

State of Arizona Office of the Auditor General

PERFORMANCE AUDIT

**ARIZONA STATE
LOTTERY
COMMISSION**

**Report to the Arizona Legislature
By Debra K. Davenport
Auditor General**

**June 2002
Report No. 02-02**

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**STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL**

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

June 3, 2002

Members of the Arizona Legislature

The Honorable Jane Dee Hull, Governor

Mr. Geoffrey Gonsler, Executive Director
Arizona State Lottery Commission

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Arizona State Lottery Commission. This report is in response to an August 9, 2001, resolution of the Joint Legislative Audit Committee. The performance audit was conducted under the authority vested in the Auditor General by A.R.S. §41-1279 and as part of the Sunset review set forth in A.R.S. §41-2951 et seq. I am also transmitting with this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Arizona State Lottery Commission agrees with all of the findings and plans to implement 10 of the 11 finding recommendations and implement 1 finding recommendation in a different manner.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on June 4, 2002.

Sincerely,

Debbie Davenport
Auditor General

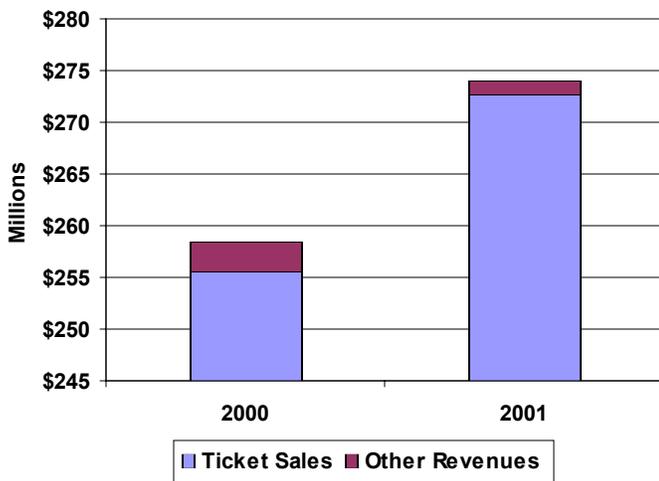
Enclosure



Arizona State Lottery Commission

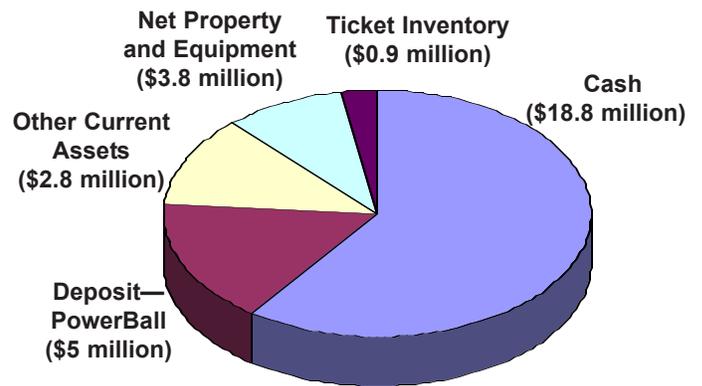
Services: The statutory purpose of the Arizona State Lottery Commission is to “oversee a state lottery to produce the maximum amount of net revenue consonant with the dignity of the State.” The Lottery markets a variety of games through a network of nearly 2,570 retailers in order to earn revenue for the State General Fund and several state programs. The Lottery's responsibilities include ensuring game integrity, monitoring retailer sales and compliance, investigating allegations of criminal activity related to Lottery tickets, and overseeing outside contractors.

Program Revenue: \$274 million
(fiscal year 2001)

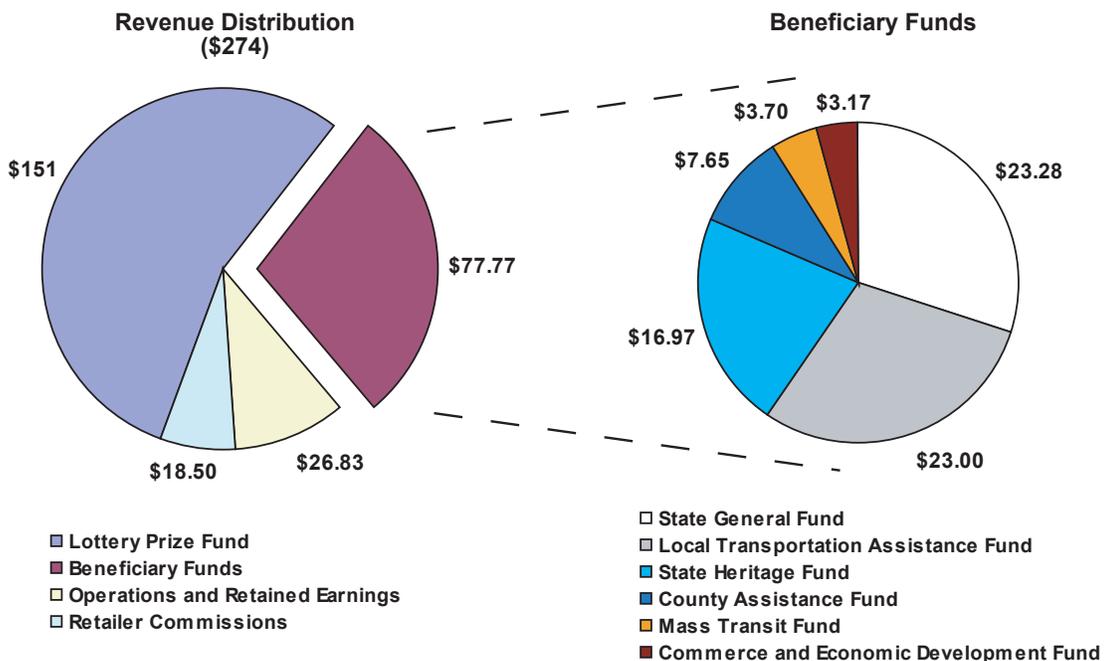


Assets: \$31,312,009 (fiscal year 2001)

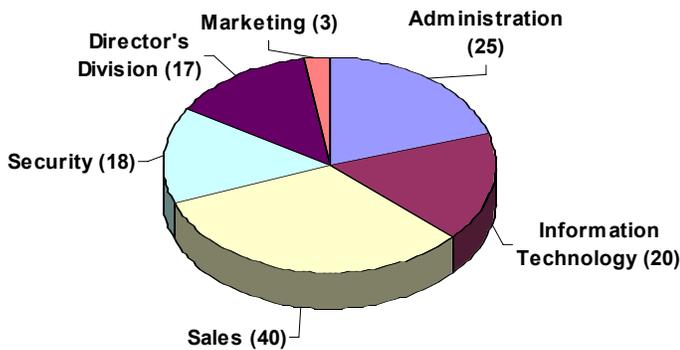
The Arizona State Lottery Fund's assets totaled approximately \$31.3 million in June 30, 2001.



Distribution of Lottery Revenues
Fiscal Year 2001
(in Millions)



Personnel: 123 full-time equivalent staff (fiscal year 2001)



Facilities and Equipment: The Arizona Lottery owns its Phoenix facility at 4740 East University Drive. It also leases an office at 4010 East Grant Road in Tucson.

The Lottery's equipment includes typical office equipment such as furniture and computer equipment. In addition, the Lottery leases 321 Instant-Ticket Vending Machines, which are located at supermarket chains.

Program Goals (fiscal years 2002-2004):

1. To sustain revenue.
2. To continue to increase agency efficiency.
3. To expand public awareness regarding the Lottery's image, beneficiaries, winners, and products.
4. To enhance retailer relationships.
5. To promote responsible gaming.
6. To attract and retain high-quality employees.
7. To support diversity in the workplace.

Adequacy of Goals, Objectives, and Performance Measures:

The Lottery's 7 goals appear to be reasonably aligned with its mission, and it has established 12 objectives and 33 performance measures in line with its goals. However, the Lottery could improve some of its goals, objectives, and performance measures. For example:

- The Lottery should amend its first goal to better reflect its statutory purpose. Instead of seeking to sustain revenue, the Lottery should strive to increase revenue in order to improve its ability to support the state programs it earns revenues for.
- The Lottery should add new objectives and performance measures such as:
 - ◆ Monitoring retailer compliance with Lottery rules and regulations. (Goal 2)
 - ◆ Increasing the public's knowledge of Lottery games, and the programs that Lottery dollars support. (Goal 3)
 - ◆ Recruiting and retaining Lottery retailers. (Goal 4)
 - ◆ Enforcing underage wagering laws. (Goal 5)

SUMMARY

The Office of the Auditor General has conducted a performance audit and Sunset review of the Arizona State Lottery Commission, in response to an August 9, 2001, resolution of the Joint Legislative Audit Committee. This performance audit was conducted under the authority vested in the Auditor General by A.R.S. §41-1279 and as part of the Sunset review set forth in A.R.S. §41-2951 et seq.

The statutory purpose of the Arizona State Lottery Commission is “to oversee a state lottery to produce a maximum amount of net revenue consonant with the dignity of the State.” The Arizona Lottery’s mission is to support Arizona programs for the public benefit by maximizing revenue in a responsible manner. In fiscal year 2001, the Lottery transferred nearly \$78 million to beneficiary funds, such as the Local Transportation Assistance Fund, the State Heritage Fund, and the State General Fund, and an additional \$1.5 million from unclaimed prizes to support the Court Appointed Special Advocate program.

The Lottery Should Do More To Maximize Its Sales (See pages 15 through 24)

Although the Arizona Lottery has made improvements to increase sales, overall revenues show little change. In the past 5 years, the Lottery has updated its online games, modified instant-ticket games, added higher-priced instant tickets, and implemented annual sales and marketing strategies. In spite of these improvements, online game sales, which tend to vary according to jackpot levels, have decreased. These declining online game sales have offset most of the increased instant-ticket sales. For example, annual instant-ticket sales averaged \$83.5 million and online sales averaged \$177.4 million between fiscal years 1994 and 1997; however, during the 4-year period from fiscal years 1998 through 2001, average annual instant-ticket sales rose to \$121.0 million, while average online sales fell to \$140.8 million.

In addition, in an effort to increase sales, in 1997 the Legislature increased the percentage of Lottery revenues paid out in prizes, and decreased the percentage going to state programs. Even though instant game sales increased by 30 percent between 1997 and 2001, the increased prize payouts resulted in a net reduction in the total amount instant games provided to beneficiary funds, from \$33 million to \$29 million. To further increase instant-ticket sales, the Lottery should expand its use of instant-ticket vending machines, which have proven successful in Arizona in increasing sales, and introduce more variety in instant-ticket prices. The Lottery should also develop and submit to the Lottery Commission a plan to implement new types of instant tickets, such as pull-tab tickets, which are used by other states such as Missouri and Kentucky.

In addition, the Lottery could enhance its overall sales by more effectively using its sales representatives and expanding its retailer incentives. The Lottery should follow through with its plans to privatize ticket delivery, to enable sales representatives to provide more support to retailers, and to recruit new retailers. Finally, the Lottery should consider incentives used in other states, such as the contests with cash prizes awarded to retailers for marketing lottery products in Missouri and Connecticut. The Lottery has already begun to offer game-related promotional incentives and should continue its efforts to expand its retailer incentive program.

The Lottery Should Improve Compliance Inspections and Underage Wagering Education and Enforcement (See pages 25 through 29)

The Lottery should take steps to improve its program for monitoring retailer compliance with Lottery regulations and enforcing underage wagering laws. The Lottery's security division is responsible for regulatory enforcement, retailer education, and criminal investigations. A recent expansion of investigation staff has allowed the Lottery to add new retailer compliance and education programs. Investigative staff increased in fiscal year 2000, after the Legislature approved two new positions to enforce underage wagering requirements. First-year results from its compliance inspections indicate that the Lottery should modify its

annual inspection goal, and track inspection results. The Lottery should also develop a comprehensive program to deter underage wagering that includes ensuring retailer knowledge of the age limit for buying Lottery tickets, increasing retailers' use of age limit signs, and adopting training standards for retailers.

**Further Changes in Control
Procedures Would Enhance
Operational Improvements Made
in Recent Years
(See pages 31 through 37)**

The Lottery has made significant progress in implementing recommendations from a 1997 Auditor General report (see Report No. 97-15) to improve agency management practices in some areas, but it can still strengthen certain control procedures. The Lottery has improved oversight of its retailer network by establishing a license renewal process that includes credit checks, implementing collection procedures, and enhancing its minimum sales policy. Additionally, it strengthened its internal cash and asset controls and has improved contract and procurement oversight by developing contract oversight procedures and hiring a procurement manager. Further, the Lottery has added computer system resources and improved computer system security.

However, the Lottery should further improve its control procedures. First, the Lottery should change its current practice for distributing revenues from two games. The Lottery's current practice is inconsistent with statutory requirements and delays payments to the Heritage Fund until late in the fiscal year. Finally, the Lottery should develop additional accounting procedures for Lottery-specific transactions that are not covered in the *Arizona State Accounting Manual*.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit and Sunset review of the Arizona State Lottery Commission, in response to an August 9, 2001, resolution of the Joint Legislative Audit Committee. The audit was conducted under the authority vested in the Auditor General by Arizona Revised Statutes §41-1279 and as part of the Sunset review set forth in A.R.S. §41-2951 et seq.

Lottery History and Mission

Arizona citizens established the Lottery in 1980 through an initiative petition in the general election, and it began operating in 1981. In 1998, the voters approved a referendum to extend the Lottery until July 2003. The statutory purpose of the Arizona State Lottery Commission is:

“To oversee a state lottery to produce the maximum amount of net revenue consonant with the dignity of the State.”

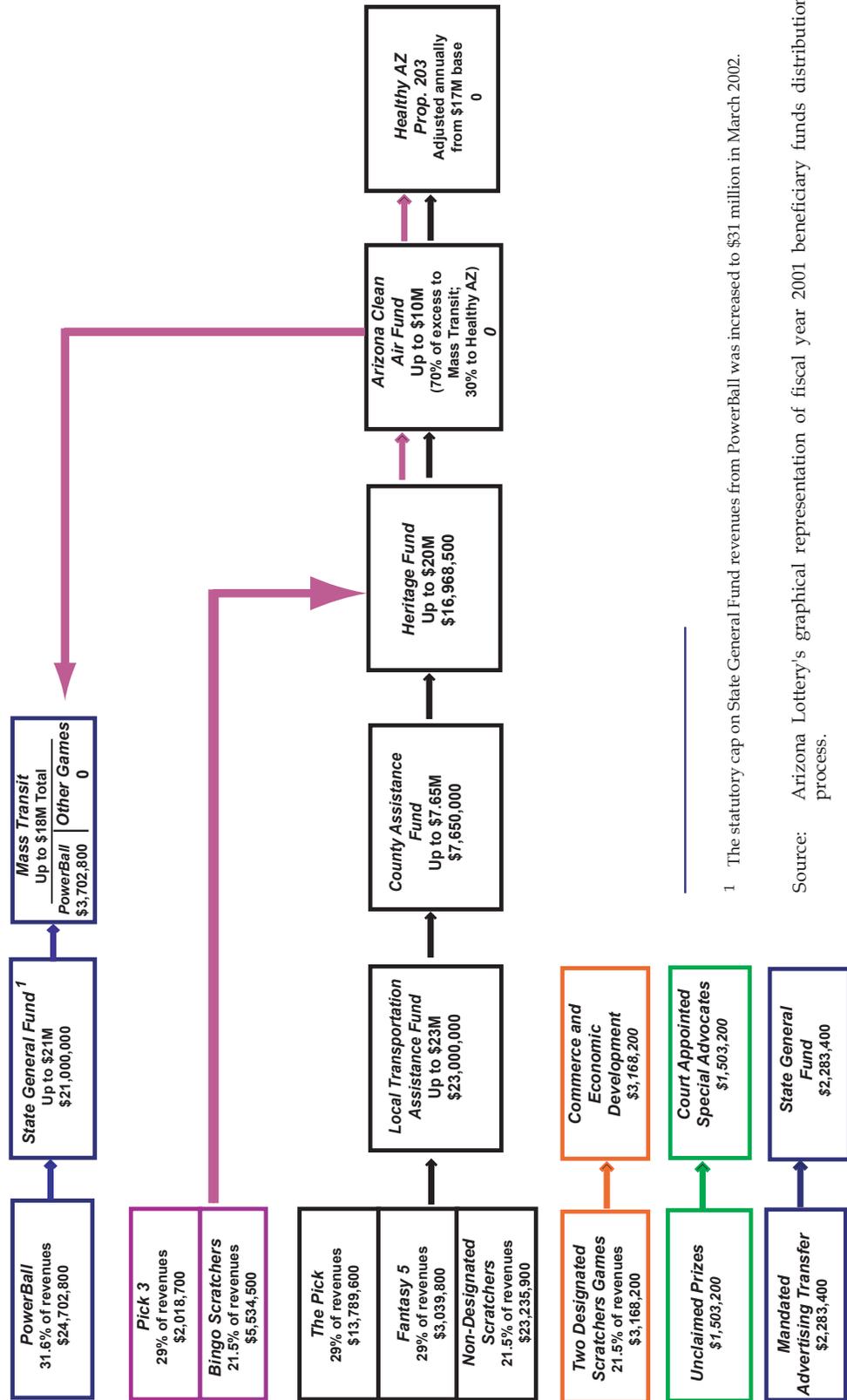
Similarly, the Lottery’s mission statement is:

“To support Arizona programs for the public benefit by maximizing revenue in a responsible manner.”

The Arizona Lottery was established to maximize revenue dedicated to various beneficiary funds, which support a variety of state and local programs, through statutory formulas. The Lottery distributed nearly \$78 million from fiscal year 2001 revenues, and another \$1.5 million from unclaimed prizes to various funds, which receive funding in accordance with state law. Appendix A (see page i) describes the nine statutorily designated beneficiary funds, and Figure 1 (see page 2) illustrates the distribution process.

Figure 1

Arizona State Lottery Commission
Distributions To Beneficiary Funds
Year Ended June 30, 2001



1 The statutory cap on State General Fund revenues from PowerBall was increased to \$31 million in March 2002.

Source: Arizona Lottery's graphical representation of fiscal year 2001 beneficiary funds distribution process.

Eight of the Lottery's nine beneficiary funds receive their distributions directly from the State Lottery Fund. The remaining fund—Court-Appointed Special Advocate Fund (CASA)—receives its financial support from the Lottery's Unclaimed Prize Fund. The CASA Fund receives 30 percent of the Lottery's unclaimed prize revenues, which amounted to more than \$1.5 million in fiscal year 2001.

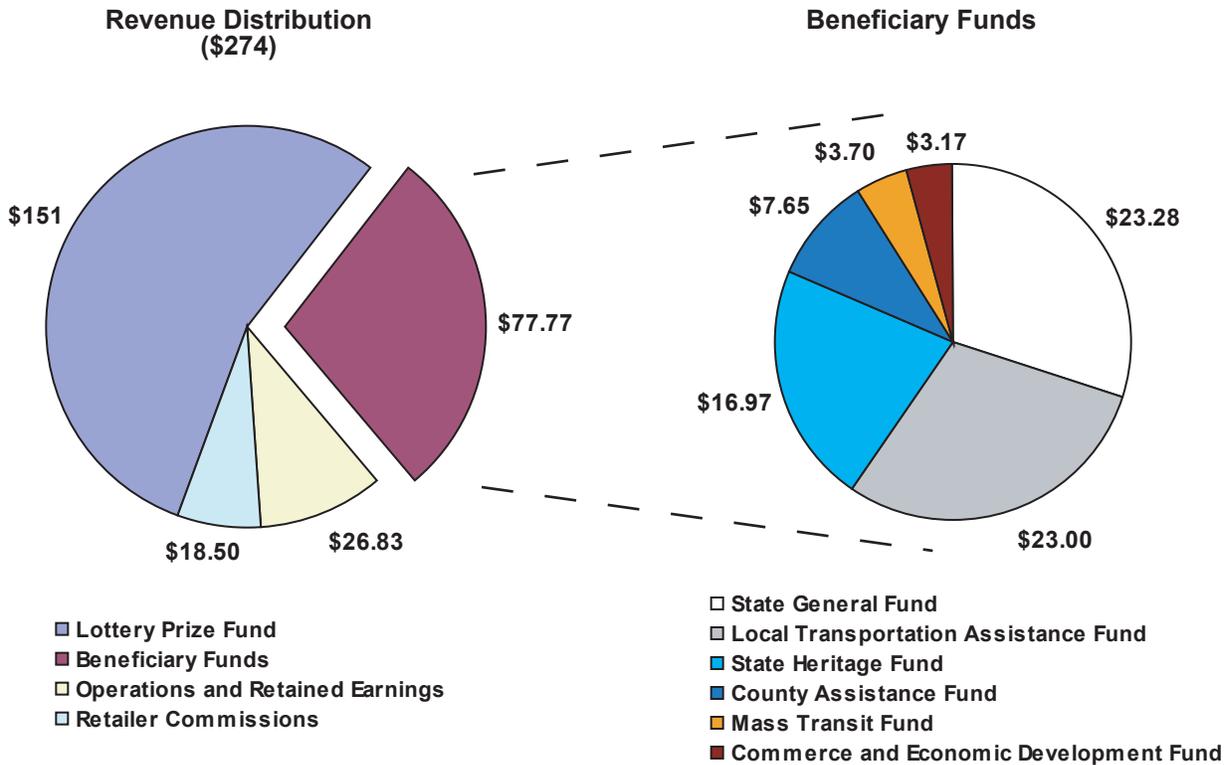
Figure 2 (see page 4) illustrates the distribution of fiscal year 2001 Lottery Fund revenues, which shows that more than 55 percent of the Lottery revenues were transferred to the Lottery Prize Fund and another 28 percent to beneficiary funds. The State General Fund and the Local Transportation Assistance Fund received most of the revenues distributed to beneficiary funds. Two of the funds, the Clean Air Fund and Healthy Arizona, did not receive any revenues in fiscal year 2001.

The amount of Lottery monies distributed to state programs has declined in recent years. As shown in Figure 3 (see page 5), distributions peaked in fiscal year 1990, when they totaled almost \$113 million. Between fiscal years 1994 and 1997, the Lottery distributed a total of nearly \$343.4 million to state programs. In contrast, the Lottery distributed a total of \$319.7 million between fiscal years 1998 and 2001, which represents a decline of 6.9 percent from the previous 4-year period. Decreased sales of online game types, and statutory changes in distribution formulas, which took effect in fiscal year 1998, contributed to this decline. (See Finding I, pages 15 through 24, for further discussion.) The decline in online game sales has particularly affected the amount available for distribution. Online ticket sales vary with the size of the jackpot, an unpredictable factor the Lottery cannot control. In addition, a 2001 study found that in Arizona an increase in the numbers of slot machines in Indian casinos has been associated with a decrease in lottery revenues, especially online game revenues.¹ Finally, the Lottery's advertising budget has been reduced since fiscal year 2000, which may also have contributed to the decline in online game sales.

¹ Siegal, Donald and Gary Anders, "The Impact of Indian Casinos on State Lotteries: A Case Study of Arizona," *Public Finance Review*, Vol. 29, No. 2, March 2001, 139-147.

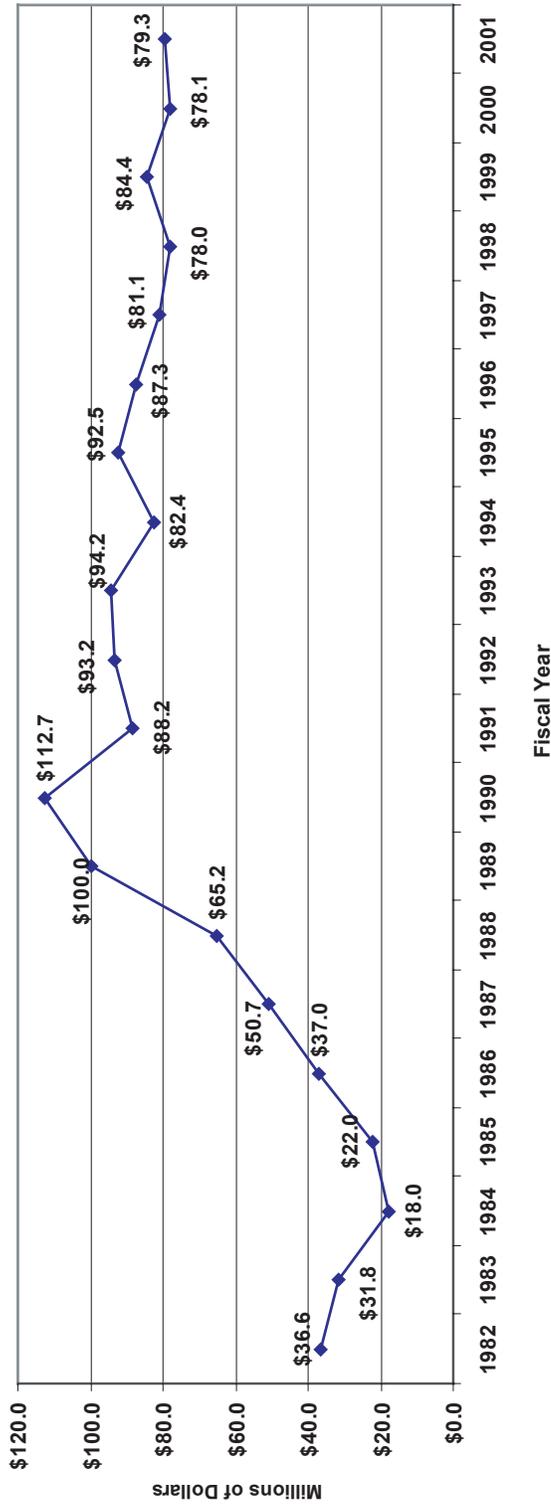
Figure 2

**Arizona State Lottery Commission
Distribution of Lottery Revenues
Year Ended June 30, 2001
in Millions
(Unaudited)**



Source: Auditor General staff analysis of the Arizona State Lottery Commission financial statements audited by Deloitte & Touche LLP for the year ended June 30, 2001, and *Arizona Lottery Revenues and Transfers to Other Funds FY 2001*.

Figure 3
Arizona State Lottery Commission
Lottery Monies Distributed To Beneficiary Funds Since Lottery's Inception¹
Years Ended June 30, 1982 Through 2001
(Unaudited)



¹ Includes distributions from unclaimed prizes to support programs such as the Court Appointed Special Advocate program.

Source: Auditor General staff analysis of Arizona State Lottery financial report *Arizona Lottery Revenues and Transfers to Other State Funds FY1982-FY2001*.

Lottery Products

The Lottery offers state-sanctioned games of chance, which are delivered in both an online and instant-ticket format. Since inception, the Lottery has sold more than 292.4 million winning tickets and awarded more than \$2.7 billion in prize money.

Arizona Lottery Online Games

Online Games—The Pick™, PowerBall®, Fantasy 5™, and Pick3™ are called online games because retailers use computer terminals to record the numbers players select. Players attempt to select numbers that will match numbers drawn biweekly or throughout the week to win cash prizes. The Pick, Fantasy 5, and Pick3 games are offered within state boundaries only. PowerBall, however, is a multi-state online game operated jointly by the 22 states forming the Multi-State Lottery Association (MUSL). Twenty-one of the 22 MUSL member states participate in the PowerBall game. In fiscal year 2001, online sales revenues were nearly \$135.8 million.



Players choose 6 out of 41 numbers ranging from 1 to 41. Minimum \$1 million jackpot.



Players pick 5 out of 49 numbers (from 1 to 49) for the first set of numbers, and 1 out of 42 numbers (from 1 to 42) for the second set (the PowerBall). Minimum jackpot is \$10 million.



Players select 5 out of 35 numbers (from 1 to 35). Maximum jackpot is \$50,000.



Players pick any 3-digit number from 000 to 999. Top prize is \$500.

Arizona Lottery Instant-Ticket Games



The Lottery's instant-ticket games are called Scratchers.SM

Called ScratchersSM, Arizona's instant-ticket games offer immediate results to players when they scratch off latex-covered play areas on the tickets. A player can win an instant-ticket game by matching three identical symbols or figures, adding numbers for a specific total, or playing familiar game styles like tic-tac-toe or bingo. The Lottery offered 29 instant-ticket games in fiscal year 2001. By law, the Lottery must offer two instant-ticket games a year to benefit state economic development programs. Along with its traditional \$1 product, the Lottery now offers \$2, \$3, and \$5 instant-ticket games. In fiscal year 2001, instant-ticket sales revenues were \$136.9 million.

Lottery Retailers

The Lottery has nearly 2,570 retailers licensed to sell its products. These include convenience stores, grocery chains, independent food stores, liquor stores, and truck stops. Lottery retailers receive 6.5 to 7 percent in sales commissions. In fiscal year 2000, the Lottery implemented an incentive program to award an extra 0.5 percent commission above the standard 6.5 percent to retailers with additional sales and promotions efforts. Grocery and chain convenience stores—such as Circle K convenience stores, and the Fry's, Safeway, and Bashas' grocery chains—accounted for more than 62 percent of the Lottery's total sales in fiscal year 2001.

Organizational Oversight and Structure

A.R.S. §5-502 established the Arizona State Lottery Commission, which oversees the Lottery. The Lottery Commission consists of five Governor-appointed members, who are confirmed by the Arizona Senate. The Commission meets monthly to make recommendations or set policy, approve or reject Lottery Directory reports, approve Lottery games, and transact other Lottery business. The Governor also appoints an executive director to administer Lottery operations. The director serves as the Commission's

secretary and executive officer. As of February 2002, the Lottery had a total of 123 full-time equivalent (FTE) employees in the following divisions:

- **Director's Division (17 FTE)**—This division oversees agency operations, game design, internal audit, administrative rules, human resources, risk management, communications programs such as “Where the Money Goes,” and compulsive gambling programs.
- **Administration (25 FTE)**—The administration division is responsible for budget and strategic planning, accounting, payroll, procurement, and purchasing, and the Phoenix and Tucson claims stores where the public can purchase tickets and redeem winning tickets. The claims stores are located in Lottery offices.
- **Sales (40 FTE)**—The sales division is responsible for sales planning, ticket distribution to retailers, retailer promotions, incentive plans, and training; and field support for the retail outlets.
- **Marketing (3 FTE)**—The marketing division is responsible for advertising and marketing research. In addition, division personnel act as a liaison to broadcast and advertising vendors.
- **Security (18 FTE)**—The security division licenses retailers, conducts investigations, maintains security in the Lottery's warehouse and claims stores, and monitors online game broadcast drawings. The division is also responsible for ensuring game integrity, monitoring retailer compliance with administrative rules, reinforcing prevention of underage wagering, and investigating allegations of criminal activity, such as lottery ticket theft and fraud.
- **Information Technology (20 FTE)**—This division is responsible for network management, telecommunications, computer operations, programming development, technical support, and computer system security.

Budget, Revenues, and Expenditures

The Legislature approves the Lottery's annual budget based on projected ticket sales revenues. Annually, the Lottery receives authority to spend monies from the State Lottery Fund, which receives its revenues primarily from ticket sales. Table 1 (see page 10) summarizes the Lottery's actual revenues and expenditures for fiscal years 1999, 2000, and 2001. Total ticket sales during these three fiscal years were above \$250 million. The highest sales occurred in fiscal year 2001, when total sales were nearly \$272.7 million.

In fiscal year 2001, the Lottery's administrative expenses were \$44.5 million, or approximately 16.3 percent of gross Lottery revenues. By statute, the Lottery is restricted to spending no more than 18.5 percent of annual gross revenues to operate the Lottery. State statutes also restrict advertising of expenditures and mandate retailer commissions, as shown in Table 2 (see page 11).

Audit Scope and Methodology

This audit focused on the Department's progress in addressing concerns identified in the Auditor General's 1997 performance audit report and Sunset review (Report No. 97-15). This audit also included a review of the Lottery's compliance inspection program, and its use of special investigators. This performance audit report and Sunset review includes finding and recommendations in three areas:

- Although the Lottery has implemented most sales-related recommendations from the 1997 audit, it should still do more to maximize sales and increase returns to state beneficiaries. For example, the Lottery should increase its use of instant-ticket vending machines, consider adding new games, and make better use of its sales force.
- The Lottery should take steps to improve its retailer compliance inspection program, and it can also do more to enforce underage wagering laws and rules.

Table 1

**Arizona Lottery Commission
Schedule of Revenues, Expenses, and Retained Earnings
Years Ended June 30, 1999, 2000, and 2001
(Unaudited)**

	1999	2000	2001
Revenues:			
Lottery ticket sales:			
Instant	\$102,924,766	\$120,593,632	\$124,259,935
Economic Development	6,514,717	8,889,811	12,643,498
PowerBall	93,698,288	69,723,954	74,291,623
Lotto/Pick	48,651,557	41,397,014	44,984,263
Fantasy 5	8,975,930	8,396,212	9,911,652
Pick 3	<u>7,498,118</u>	<u>6,552,320</u>	<u>6,579,893</u>
Total Lottery ticket sales	268,263,376	255,552,943	272,670,864
Transfers to the State Lottery Prize Fund ¹	<u>(144,011,884)</u>	<u>(140,127,307)</u>	<u>(150,887,186)</u>
Net Lottery ticket revenue	124,251,492	115,425,636	121,783,678
State General Fund appropriation ²		1,500,000	
Retail license fees	12,467	10,117	18,976
Other	<u>882,776</u>	<u>1,257,836</u>	<u>1,292,312</u>
Total revenues	<u>125,146,735</u>	<u>118,193,589</u>	<u>123,094,966</u>
Expenses:			
Retailers' commissions	17,437,399	16,798,267	18,496,981
Advertising and promotion	8,997,172	8,104,360	7,155,050
Online system	8,498,261	8,089,857	8,541,672
Tickets purchased	2,508,819	1,994,522	2,322,238
Personal services and employee-related	4,289,862	4,554,561	4,951,238
Contract services	327,983	698,904	531,690
Other administrative ³	<u>2,385,218</u>	<u>2,222,110</u>	<u>2,545,132</u>
Total expenses	<u>44,444,714</u>	<u>42,462,581</u>	<u>44,544,001</u>
Net income before transfers to other State of			
Arizona funds	80,702,021	75,731,008	78,550,965
Transfers to other State of Arizona Funds	<u>(80,473,300)</u>	<u>(75,442,600)</u>	<u>(77,772,900)</u>
Increase in retained earnings	228,721	288,408	778,065
Retained earnings, beginning of year	<u>7,379,873</u>	<u>7,608,594</u>	<u>7,897,002</u>
Retained earnings, end of year	<u>\$ 7,608,594</u>	<u>\$ 7,897,002</u>	<u>\$ 8,675,067</u>

¹ The State Lottery Prize Fund, an Expendable Trust Fund of the State of Arizona, accounts for cash and assets held by the Commission in a trustee capacity. The Commission transfers monies to the Fund to pay prizes to winning ticket holders.

² In 2000, the Commission was appropriated \$1.5 million to provide additional advertising.

³ Includes depreciation expenses of \$650,546, \$313,520, and \$308,212, for 1999, 2000, and 2001, respectively.

Source: Auditor General staff analysis of the Arizona Lottery Commission financial statements audited by Deloitte & Touche LLP for the years ended June 30, 1999, 2000, and 2001.

Table 2

**Arizona State Lottery Commission
 Lottery Expenditures and Related Statutory Restrictions
 Year Ended June 30, 2001
 (Unaudited)**

	Expenditures (millions)	Percentage	
		Actual	Statutory Limit ¹
Administrative expenses ²	\$44.5	16.3%	18.5%
Advertising	7.2	2.6	4.0
Retailer commission	18.5	6.8	6.5 – 7.0

¹ The statutory limit on administrative expenses and advertising is a percentage of gross revenues; the statutory limit on retailer commissions is a percentage of total sales.

² Includes advertising and retailer commissions.

Source: Auditor General staff analysis of the Arizona Lottery Commission financial statements audited by Deloitte & Touche LLP for the year ended June 30, 2001, and Arizona Revised Statutes §5-505.

- The Lottery has taken several steps to improve management practices and internal controls since the 1997 performance audit, but it should further improve some of its control procedures.

Auditors used a variety of methods to study the issues addressed in this report, including interviewing Lottery Commission members, management, and staff; attending four Lottery Commission meetings between September 2001 and February 2002; interviewing members of the Lottery’s Retailer Advisory Committee, and representatives from selected retailers, such as Bashas’, Safeway, IGA, and 7-Eleven; interviewing the directors of Arizona Food Marketing Alliance and the Arizona Licensed Beverage Association; reviewing statutes, rules, and Lottery policies and procedures; reviewing annual reports and audited financial statements for fiscal years 1997 through 2001; reviewing strategic planning documents for fiscal years 2001 and 2002, including budget plans, sales and marketing plans, and security plans; and reviewing industry comparison data in the *North American Association of State and Provincial Lotteries 2001 Lottery Resource Handbook*, and the *LaFleur’s 2001 World Lottery Almanac*; and other literature. The following specific methods were also used:

- To assess the Lottery's progress in improving sales and to identify other strategies that the Lottery could pursue to improve sales, auditors examined the Lottery's current sales practices such as current retailer incentive plans and sales representatives' job activities; contacted sales directors in seven states to identify their strategies for increasing instant-ticket sales and online ticket sales; and compared instant-ticket sales trend data among Lottery retailers who have Instant-Ticket Vending Machines and those who do not.¹

- To evaluate the adequacy of the Lottery's new compliance inspection program and underage wagering enforcement efforts, auditors examined the Lottery's new retailer compliance inspection procedures; reviewed the Lottery's retailer compliance inspection form to ensure it addressed compliance with underage wagering regulations; contacted security directors in seven states to determine how they conducted retailer compliance inspections; interviewed investigators at the Arizona Department of Liquor Licenses and Controls to determine how they conduct compliance inspections and enforce underage drinking laws; and reviewed monthly investigation reports for February 1, 2000 through December 31, 2001, and 19 criminal investigation files for all stolen ticket investigations conducted in October 2001 to identify the actual activities undertaken by Lottery investigators.²

- To assess the Lottery's efforts to improve management practices and internal controls, auditors conducted an internal control review of the Lottery's financial controls including cash-handling activities in its Phoenix and

¹ Auditors contacted officials in Connecticut, Kentucky, Maryland, Missouri, New Jersey, New Mexico, and Washington. These states' 2000 per capita instant-ticket sales were close to the national per capita instant-ticket sales average, and were comparable to Arizona in terms of population and competition with other gaming activities, such as tribal casinos or riverboat gambling.

² Auditors contacted security directors from the same states identified previously.

Introduction and Background

Tucson claims stores; examined computer system controls and resources; and reviewed policies and procedures for accounting and security practices unique to the Lottery.

The audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Commissioners of the Arizona State Lottery Commission, and the Executive Director of the Arizona State Lottery and his staff, for their cooperation and assistance throughout the audit.

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FINDING I**THE LOTTERY SHOULD DO MORE
TO MAXIMIZE ITS SALES**

The Arizona Lottery should take additional steps to maximize its ticket sales. While the Lottery has made improvements to increase sales in recent years, total sales have not grown substantially. As a result, state funds such as the Heritage Fund and Mass Transit continue to receive less money than the law allows, and some programs continue to receive no Lottery funding at all. The Lottery should take several steps to increase sales, including installing additional instant-ticket vending machines, adding higher-priced instant tickets and pull-tab tickets, more effectively using its sales representatives, and expanding its retailer incentive plan.

**Despite Steps To Increase Sales,
Declining Online Game Revenues
Offset Instant Ticket Revenue Growth**

In response to previous Auditor General recommendations, the Lottery has in recent years taken several steps designed to strengthen sales and maximize state revenue. In spite of these improvements, total sales for fiscal years 1998-2001 were about the same as the previous 4-year period. This lack of growth in total sales, coupled with increases in the percentage of Lottery revenues being paid out in prizes, has lowered revenues for beneficiary funds that depend on Lottery funding.

The Lottery has taken steps to increase sales—Responding to Auditor General recommendations, the Lottery has taken several steps to strengthen sales in order to maximize state revenue. In 1997, an Auditor General report (see Report No. 97-15) found that several Lottery practices contributed to poor sales and inefficiently used resources, limiting monies available for state programs. The report recommended revamping online games, adding additional games to the game mix, replacing instant-ticket games more quickly, and varying game prices and prize structures. The report also recommended implementing long-term planning and using sales staff more productively to increase its sales. The Lottery responded by:

The Arizona Lottery improved sales practices in response to a 1997 Auditor General report.

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- Updating The Pick and Fantasy 5;
- Adding a 3-number game, Pick3;
- Shortening the average time instant-ticket games stay in the market to 16 weeks, reducing the number of tickets printed for each game, and adding \$3 and \$5 tickets;
- Increasing instant-ticket prize payouts;
- Modifying ticket size and appearance and obtaining additional instant-ticket vending machines (ITVMs);
- Addressing marketing strategy and long-term planning by implementing annual updates of strategic plans for marketing, instant tickets, online games, media, and communications and research; and
- Restructuring its sales department, including creating a promotions section, and instituting a new sales department incentive plan.

Further, the Lottery is now conducting research as a basis for making better business decisions and regularly evaluates its advertising expenditures to maximize their effect on sales. The Lottery contracts with two advertising agencies to conduct market research, collect and analyze data, develop market and media strategies, and implement agreed-upon recommendations based on available resources. In addition to its primary advertising contract, the Lottery has a separate contract for advertising services to the Hispanic market. Its primary advertising agency provides the Lottery with an annual market research tracking study report and monthly findings regarding player demographics and market trends. Further, the Lottery evaluates its advertising mix, adjusting amounts spent on television, radio, print media, and transit, to reach the targeted audience with the desired message for the best value.

Decreased online sales result in less money for beneficiary funds— Despite these changes, Arizona’s online games, like those in many other states, have experienced a drop in sales. As illustrated in Figure 4, declining sales of online tickets have offset

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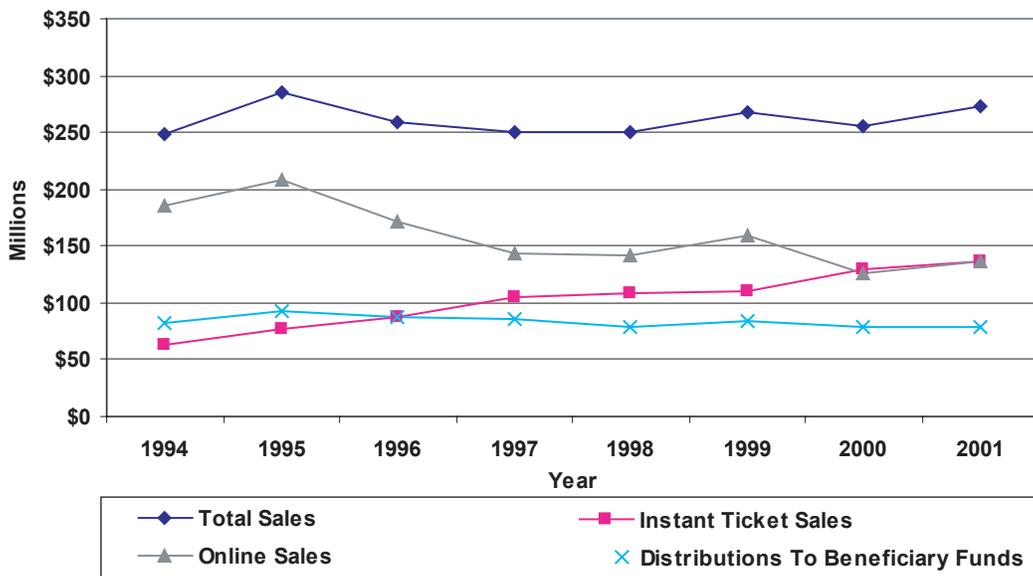
Declining online sales have offset gains in instant-ticket sales.

increases in instant ticket sales, and have essentially kept total Lottery revenues relatively unchanged.

Instant-ticket sales respond to changes in prize payouts, ticket design, and marketing strategies, but online ticket sales vary with the size of the jackpot, an unpredictable factor the Lottery cannot control. For example, annual instant-ticket sales averaged about \$83.5 million and online sales averaged approximately \$177.4 million between fiscal years 1994 and 1997. However, during the 4-year period from fiscal years 1998 through 2001, average annual instant-ticket sales rose to approximately \$121 million, while average online ticket sales fell to about \$140.8 million.

Figure 4

**Arizona State Lottery Commission
Sales Compared To Total Distributions To Beneficiary Funds
Years Ended June 30, 1994 Through 2001
(Unaudited)**



Source: Auditor General staff analysis of the Arizona State Lottery Commission financial statement audited by Deloitte & Touche LLP for the fiscal years ended June 30, 1994 through 2001.

Increased prize payouts reduce monies for beneficiary funds—

An increase in the percentage of Lottery revenues returned to participants in the form of prize money has resulted in less money going to beneficiary funds that receive Lottery revenues. As a means of increasing overall sales, the Legislature changed the distribution formula to increase prize payouts, particularly for instant tickets, starting in fiscal year 1998. Prior to September 1997, beneficiary funds received 31.5 percent of all sales. However, beginning September 30, 1997, the distribution formula changed to one in which the funds received 29 percent of all online game revenues, and 21.5 percent of instant-ticket sales.¹ Thus, even though instant game sales increased by 30 percent between 1997 and 2001, the amount of monies beneficiary funds received from instant games dropped from approximately \$33 million to \$29 million.

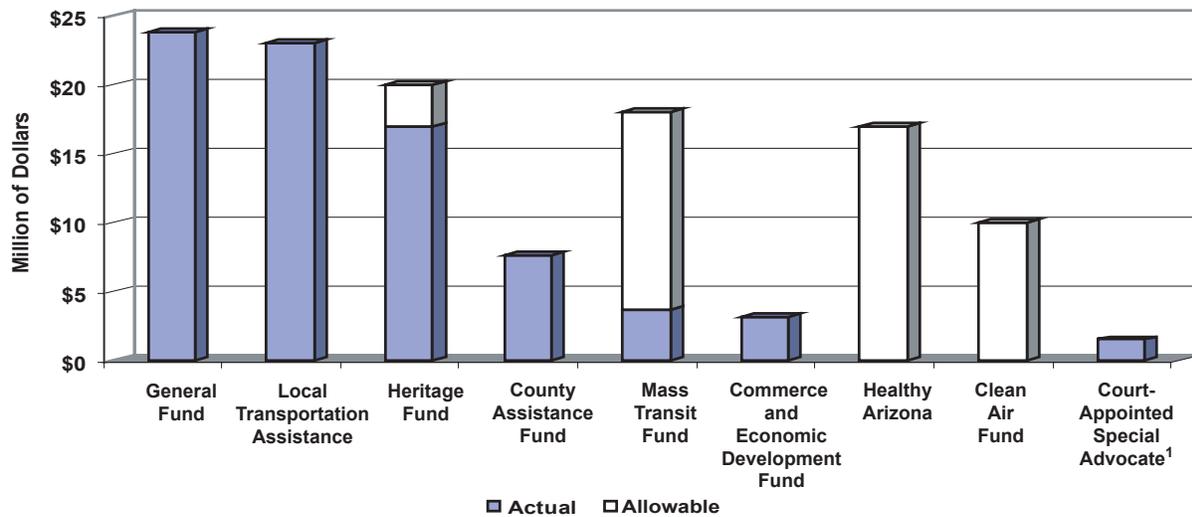
Beneficiary funds affected—The decline in Lottery monies distributed to the State has affected some state lottery beneficiaries. Beneficiary funds, including the State General Fund, received \$343.4 million over the 4-year period from fiscal year 1994 through fiscal year 1997. However, these funds received a total of only \$319.7 million from fiscal year 1998 through fiscal year 2001, or \$23.7 million less. Because of falling distributions, funds such as the Heritage Funds and Mass Transit have been funded at levels below those permitted by law (see Figure 5, page 19). For example, the Heritage Funds have not received full funding since 1998. Additionally, the law permits Mass Transit to receive up to \$18 million annually in Lottery monies, but in fiscal year 2001, it received only \$3.7 million. Further, other programs have never received Lottery revenue, including Healthy Families, Health Start, the Board of Regents' health education system, teenage pregnancy programs, disease control research, and the Women, Infants and Children food program, collectively referred to as "Healthy Arizona." Additionally, the Clean Air Fund, which received a one-time distribution of \$500,000 from the Lottery's unclaimed prize fund in 1997, has not subsequently received any of its potential \$10 million annual distribution.

The State Heritage Fund and other programs have received less money than permitted by law.

¹ Laws 1999, 1st S. S., Ch. 3, §12 subsequently increased the PowerBall® distribution to 31.6 percent of sales for fiscal years 2000 and 2001. Laws 2001, Ch. 238, §16 made the same distribution increase effective for fiscal years 2002 and 2003.

Figure 5

**Arizona State Lottery Commission
Distributions To Beneficiary Funds
Year Ended June 30, 2001
(Unaudited)**



¹ The Court-Appointed Special Advocate (CASA) program receives its monies from the Lottery's Unclaimed Prize Fund.

Source: Auditor General staff analysis of A.R.S. §5-522 and Arizona State Lottery Commission financial statement audited by Deloitte & Touche LLP for the year ended June 30, 2001.

However, even if the Lottery increases sales, some of these programs may never receive full funding. In order for all beneficiaries to receive their maximum distribution, total Lottery sales would need to increase between a minimum of \$422.8 million to nearly \$543 million in annual sales.¹

The Lottery Should Take Additional Steps To Increase Sales

The Lottery should take several additional steps to further increase instant ticket sales and attempt to enhance online sales. These steps include expanding the use of instant-tick-

¹ This range takes into account the different percentages that PowerBall, state online games like The Pick, and instant-ticket games contribute to the State. It excludes economic development instant-ticket sales.

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The Lottery has successfully introduced ITVMs to some retailers.

et vending machines, adding new types of instant tickets that have proven to be successful in other states, using sales representatives' time more effectively, and expanding its retailer incentive plan.

Expanding the use of instant-ticket vending machines (ITVMs)—The Lottery has successfully introduced ITVMs to its retailer market, but should expand their use to further increase instant-ticket sales. The Lottery first began installing ITVMs in fiscal year 1994. Currently, the Lottery has 321 ITVMs, nearly all located in chain grocery stores, with a total annual lease cost to the Lottery of \$847,440. Nontraditional retailers, such as truckstops and gas stations, have the remaining ITVMs. One hundred retailers that received ITVMs in 2001 experienced an average 38 percent increase in instant-ticket sales, totaling \$6.04 million in 2001, compared to \$4.37 million in fiscal year 2000.¹ Overall, in fiscal year 2001, chain grocery stores with ITVMs averaged about \$78,000 in instant-ticket sales compared to about \$35,000 in chain grocery stores without ITVMs.

Although ITVMs can be an economical method of increasing sales, they were located at only 8 percent of Arizona Lottery retailers in fiscal year 2000. According to *LaFleur's 2001 World Lottery Almanac*, this is less than half the average percentage for other state lotteries. The Lottery should identify the number of additional retailers that would benefit from having an ITVM, and determine the expected costs and benefits of placing ITVMs at additional retailers. For example, currently, the annual lease for each 12-game machine is \$2,640. Taking into account the percentage of sales dedicated to prize payments, stores that have 12-game ITVMs need to increase

Photo 1:

Instant-Ticket Vending Machine (ITVM)



The Lottery leases 321 ITVMs, which are mostly located in supermarkets.

¹ Fiscal year 2001 sales figures include 3 months of sales (July-September 2000) before ITVMs were installed.

instant-ticket sales by only \$127 per week in order to offset the lease fee incurred by the Lottery. ITVMs with more or fewer bins have different lease costs and may be suitable for some retailers. According to Lottery officials, ITVMs also offer other benefits. First, because ITVMs are self-service ticket dispensers, checkout clerks and other store personnel need not actively sell or account for tickets. Further, ITVMs safeguard tickets and money, which are locked in a machine rather than on or beneath a sales counter or in a cash register. Their visibility also provides advertising for instant tickets, which are often an impulse purchase. Once its study of costs and benefits is complete, the Lottery should request authorization from the Legislature to use monies from the Lottery Fund to lease the additional ITVMs.

Implementing new instant-ticket types and denominations— The Lottery should develop and submit to the Lottery Commission plans to implement new types of instant tickets and at a variety of prices. For example, pull-tab instant tickets have allowed several states, such as Missouri and Kentucky, to increase their instant-ticket sales and enter nontraditional retail markets such as restaurants, bars, and clubs. Pull-tab instant tickets require that a player pull off a paper tab rather than scratching a latex covering to determine a winning ticket. They have generally been sold in 25- and 50-cent denominations, although some states have \$1 pull-tabs. In fiscal year 2000, 10.3 percent of Kentucky’s instant-ticket sales and 9.7 percent of Missouri’s instant-ticket sales were derived from pull-tabs. The Lottery’s statutes allow it to offer different game play-styles, which include pull-tab instant tickets. Pull-tabs might allow the Lottery to increase its sales in restaurants and bars. Currently, there are only 35 restaurants and bars in Arizona that sell Lottery tickets.

In addition to pull-tabs, some states sell instant tickets at prices that Arizona does not use. For example, 20 of 37 lottery states have \$10 “scratcher” instant tickets, and one state, New Hampshire, has a top instant-ticket price of \$7. In contrast, the Arizona Lottery’s highest-priced ticket is \$5. Higher-priced tickets have helped increase sales in other states. For example, Connecticut had \$141.4 million in \$10-ticket sales in fiscal year 2000, or 27 percent of its total instant-ticket sales. Similarly, Michigan had \$106.2 million in \$10-ticket sales, or 16.5 percent

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of its total fiscal year 2000 instant ticket sales. The Lottery plans to introduce its first \$10 instant-ticket game, and offer more \$3 and \$5 games in fiscal year 2003.

In 1997, the Auditor General recommended that the Lottery make better use of its sales representatives.

Using sales representatives more effectively—The Lottery should use its sales representatives in ways that enable them to effectively increase sales. In 1997, the Auditor General recommended that the Lottery find better ways to handle ticket distribution and allow sales representatives to spend more time working to increase sales (see Report No. 97-15), because they were spending most of their time delivering tickets. The Arizona Lottery recently issued a Request for Proposals for instant-ticket printing and a ticket delivery and management system. The Request for Proposal for a new ticket distribution system includes provisions not only to contract for ticket delivery but also for the contractor to track sales and calculate data to help sales representatives provide retailers with the best products for their locations. The Lottery anticipates that the successful bidder will fully implement the system by January 14, 2003.

Sales representatives in other states engage in sales support, such as informing retailers of upcoming games and events, and conducting retailer incentive programs and promotions.¹ Additionally, they discuss product displays, troubleshoot machines, and address retailer concerns. Unlike Arizona's sales representatives, they are also responsible for recruiting new retailers. Once the new ticket delivery system is in place, the Lottery should ensure that its sales representatives are trained to provide sales support responsive to retailer needs and make the sales representatives responsible for recruiting new retailers.

Some states offer a variety of retailer incentives.

Expanding retailer incentives—To encourage retailers to increase sales, the Lottery should expand its retailer incentive program. The Lottery pays one of the higher retailer sales commissions among United States lotteries, 6.5 percent, based on its sales. Additionally, retailers can earn an extra 0.5 percent annually if their sales exceed the prior year by more than 5 percent. However, other states, such as New Jersey and Missouri,

¹ Auditors surveyed sales and marketing managers from Connecticut, Kentucky, Maryland, Missouri, New Jersey, New Mexico, and Washington.

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provide retailers with sales bonuses for selling winning tickets and cashing winning tickets. Moreover, Missouri has contests and promotions between retailers with cash and prize awards for successful retailers. These incentives can change with lottery goals and encourage retailers to more actively market lottery products. The Lottery has already introduced some promotions to benefit retailers. For example, it has conducted four game-related retail promotions since April 2000. The first promotion focused on boosting sales for The Pick, while the latter three promotions attempted to boost Fantasy 5 sales. In addition to promotional incentives, the Lottery has been working with its retailer advisory group and budget analysts to revise its retailer incentive program, but to date has focused mainly on the requirements for earning the extra 0.5 percent. It should continue its efforts to expand its incentive program to increase retailer sales efforts, including considering the innovations implemented in other states.

Recommendations

1. The Lottery should identify the number of retailers who would benefit from having an Instant-Ticket Vending Machine (ITVM), document the financial benefits expected from their utilization, and study the impact of leasing or purchasing ITVMs with varying numbers of ticket bins. It should then request authorization from the Legislature to use monies from the Lottery Fund for additional ITVMs.
2. The Lottery should develop a plan to use pull-tab instant tickets to expand its retailer network and player base. The plan should be submitted to the Lottery Commission for its consideration.
3. The Lottery should follow through on its fiscal year 2003 plan to offer more \$3 and \$5 instant-ticket games and sell instant-ticket games at prices above its current \$5 tickets.
4. The Lottery should (a) follow through with its plans to subcontract the delivery of instant tickets to retailers through its instant-ticket printing vendor and (b) ensure that such a delivery system includes the ability to track sales and calculate data that helps sales representatives assist retailers.
5. Once it has the new ticket delivery system in place, the Lottery should restructure the duties of its sales representatives to include recruiting new retailers and providing sales support and training to current retailers.
6. To increase retailer sales efforts, the Lottery should continue its efforts to offer game-related retail incentives and expand its retailer incentive program with input from its retailer advisory committee and budget analysts. It should present its plan to the Lottery Commission for consideration.

FINDING II

THE LOTTERY SHOULD IMPROVE COMPLIANCE INSPECTIONS AND UNDERAGE WAGERING EDUCATION AND ENFORCEMENT

The Lottery should take steps to improve its compliance inspection program and develop a comprehensive program to enforce underage wagering laws. The Lottery's Security Division is responsible for regulatory enforcement, retailer education, and criminal investigations. A recent expansion of investigation staff has allowed the Lottery to add new retailer compliance and education programs. The compliance inspection program is designed to ensure compliance with Lottery requirements. First-year results, however, indicate that the Lottery can improve the program by modifying its inspection goal and instituting tracking measures. The Lottery should also develop a comprehensive program to monitor and deter underage people from wagering.

In recent years, the Lottery has taken steps to enhance its Security Division, which is responsible for ensuring the integrity of games and operations. The Division's duties include regulatory enforcement, retailer education, criminal investigations, ensuring game integrity, licensing, and the physical security of the Lottery's offices. The Division's staff comprises seven peace officers, including the Security Director, a chief investigator, and five special investigators.¹

Recent expansion in investigative staff has led to addition of new retailer education and regulatory enforcement programs— According to the Lottery, a recent expansion of its investigative staff has allowed the agency to enhance retailer education and regulatory enforcement. In 1999, investigative staff increased when the Legislature approved two new investigator positions to enforce underage wagering requirements. According to the

¹ By statute, the Lottery's security director must be a peace officer certified by the Arizona Police Officer Standards and Training Board (Arizona P.O.S.T). Although not required by state statute, the Lottery requires its investigative staff to have limited peace officer status.

Lottery director, having a larger investigative unit has allowed the agency to improve the entire security program. The Division's six investigators are responsible for conducting retailer education, compliance inspections, and criminal investigation activities. Since the addition of the two new investigators, the Lottery has added new retailer education and regulatory enforcement programs, including a retailer loss prevention program, a retailer compliance inspection program, and a low-volume sales program to monitor retailers who fail to meet the Lottery's minimum sales requirements.

Compliance inspection program designed to ensure compliance with Lottery requirements— The Lottery adopted this program in 2000 to improve retailer oversight. Its objective is to ensure that all licensed retailers conduct their business in compliance with established Lottery policies and procedures, and retailer rules and statutes. These regulations pertain to issues such as lottery terminal operation, prize payment limitations, placement of instant-ticket games and instant-ticket vending machines (ITVMs), and enforcement of underage wagering laws. The Lottery's special investigators conduct the inspections at retailer locations, and use a checklist to record compliance with retailer regulations. For example, the investigators record things such as whether the retailer's online terminal is functioning properly, whether instant-ticket games are displayed so customers can see them, whether the retailers have placed ITVMs in locations where retail staff can easily observe customer activity, and whether employees know prize payment redemption requirements, which limit retailer prize payments to \$599 or less.

Arizona has a more formal inspection program than some other states. Of the seven states contacted for this audit, only one had a formal compliance inspection program in place.

First-year results indicate that the Lottery can modify and improve compliance inspection program— Results from the Lottery's first year of conducting compliance inspections indicate that it can take several steps to improve the program, such as:

- **Revising its inspection goal**— The Lottery should develop a systematic plan for identifying the number of retailers to be inspected during a year. During the program's first year, the Lottery was unable to meet its goal of inspecting

each retailer each year. In calendar year 2001, investigators completed compliance inspections of 1,122 retailers, or 42 percent of the total. According to security officials, the problems they are finding mainly consist of lack of knowledge regarding prize redemption limitations and stolen ticket procedures, and incorrect handling of validated tickets. Lottery officials have determined that investigators' other duties, such as conducting criminal investigations into theft and robbery of lottery tickets, investigating complaints from retailers and the public, and conducting retailer loss prevention seminars, have a higher priority than compliance inspections.

Lottery officials plan to revise the compliance inspection goal, and have begun drafting a policy to reduce the number of compliance inspections to 500 per year, or nearly 19 percent of retailers. As part of reducing its compliance inspection goal, the Lottery should adopt a rationale for selecting the retailers to be inspected, and develop a new annual inspection plan for the Commission's approval.

- **Tracking inspection results**—The Lottery should begin tracking compliance inspection results in its database. Although the Lottery maintains a compliance inspections database that includes a field to record violations, Lottery staff do not enter violation information in the database. Entering information in a database would allow the Lottery to identify common problems that need to be corrected, such as insufficient employee training or knowledge of regulations. The Lottery could then use this information to enhance retailer training and education.

Tracking results could improve the program.

Additional steps needed to monitor underage wagering—Finally, the Lottery should expand its retailer compliance program to address underage wagering more directly. In 1999, the Legislature approved two new investigator positions to enforce underage wagering requirements beginning in fiscal year 2000. However, the Lottery has not directly used these new resources to improve monitoring and enforcement of these requirements. According to the Lottery director, the two positions were generally approved for underage wagering, but the Lottery has used them to strengthen the entire security program. Because the minimum age to play lottery games will increase from 18 to 21 in June 2003, the Lottery should begin

taking steps now to educate retailers and the public about the pending change.

To improve its ability to monitor and enforce underage wagering requirements, the Lottery should develop a comprehensive program to monitor underage wagering that includes the following components:

- **Revise its current compliance inspection checklist**—The Lottery should add questions to its compliance inspection checklist to specifically address retailer staff knowledge of minimum age requirements. Although the current checklist includes a question about the placement of ITVMs and whether they are visible to customer-service personnel, it does not include any questions that directly address awareness of underage wagering laws and rules.
- **Increase its use of age limit signs**—The Lottery has placed signs on customer-operated ITVMs reminding players of the age restrictions. Similarly, the Lottery should post age limit signs on store-operated terminals to remind players and licensed retailers about age restrictions. The Missouri and New Jersey lotteries place signs on both the customer-operated ITVMs and store-operated terminals.
- **Adopt training standards for retailers**—As part of retailer training, the Lottery should adopt some of the training standards established by Arizona Liquor Licenses and Control to enforce underage drinking laws. For example, the Lottery should remind retailers to regularly check the players' identification to ensure that they are old enough to play lottery games, train retailers to recognize invalid identification cards, and provide them with a list of acceptable identification cards.

The Lottery can enhance monitoring of underage wagering activities.

Recommendations

1. The Lottery should improve the management compliance inspections by developing a systematic compliance inspection plan to present to the Commission for its approval.
2. The Lottery should track compliance violations in a database and use it to enhance retailer training and education.
3. The Lottery should develop a comprehensive program to monitor underage wagering for the Lottery Commission's consideration that includes the following components:
 - a. Adding a question to its compliance checklist that directly addresses retailer knowledge of underage laws;
 - b. Placing signs on its online terminals to remind retailers and players about age restrictions; and
 - c. Adopting policies for retailer training similar to those that the Arizona Department of Liquor Licenses and Controls has established to enforce underage drinking laws. For example, the Lottery should train retailers to check identification on a regular basis, recognize invalid identification cards, and provide retailers with a list of acceptable identification cards.

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FINDING III

FURTHER CHANGES IN CONTROL PROCEDURES WOULD ENHANCE OPERATIONAL IMPROVEMENTS MADE IN RECENT YEARS

The Lottery has made considerable progress in implementing previous audit recommendations to improve agency management practices, internal controls, contract oversight, and information technology resources. Certain control procedures, however, can be further strengthened. In particular, the Lottery needs to amend the process it uses to distribute monies to state programs to comply with state statute, and adopt accounting procedures for Lottery-specific transactions.

Lottery Has Improved Many Management Practices

Since the Auditor General's 1997 performance audit (Report No. 97-15), the Lottery has improved a number of internal controls and acquired some needed information technology resources as recommended. Specifically, the Lottery has improved oversight of its retailer network, strengthened cash-handling controls, improved contract oversight, and added information technology security controls and resources.

Improved oversight over retailer network—The Lottery has strengthened oversight over its retailer network since the 1997 performance audit and improved management controls related to retailer oversight. Specific improvements include:

- **Instituting a license renewal process and credit checks**—The 1997 audit reported that the Lottery had not renewed retailer licenses since 1991 and did not ensure that existing retailers were creditworthy. However, in January 2001, the Lottery instituted a license renewal process, which requires

The Lottery has improved retailer licensing, collections, and minimum sales policies.

all retailer licenses to be renewed every 3 years, in accordance with regulations. The new program includes conducting criminal background and credit checks on owners and retailers. In addition, the Lottery has also centralized all licensing and renewal processes into its Security Division in order to more efficiently carry out these activities.

- **Implementation of collection policies and procedures**—The 1997 audit found that retailers were allowed to continue to sell tickets even if they had not paid for previous tickets. Retailers' debt totaled more than \$735,000 in 1997. The Lottery has since improved its debt collection policies and procedures. From June 1998 through June 2001, the Lottery used a private collections agency to collect retailer debt until receivables dropped to a level Lottery staff could manage. As a result, overall retailer debt dropped from \$735,000 in 1997 to about \$417,700 at the end of fiscal year 2001. Retailers that are out of business, bankrupt, or cannot be located owe approximately \$414,200, or 99 percent, of this amount. The Lottery has transferred these cases to the Attorney General's Office for possible legal action. Active retailers owed the remaining \$3,500. In addition to hiring a private collections agency, the Lottery instituted a new policy to prevent retailers from accumulating debt. In March 2000, the Lottery began suspending retailer licenses and deactivating retailers' computer terminals to prevent them from selling more tickets if their bank account balances fail to cover ticket expenses at least twice in a 3-year period.

- **Enforcement of minimum sales rules**—In 1997, the Lottery failed to ensure that retailers met minimum sales requirements of 400 online and 250 instant tickets per week. The Lottery now requires retailers that sell below minimum levels to pay the \$182 per-quarter telephone terminal charges. This fee will be increased to \$260 in fiscal year 2003 to fully cover telecommunications costs. According to the Lottery, in fiscal year 2001, 253 retailers paid the telephone charges, and 104 relinquished their license rather than pay the charges. The Lottery granted 276 telephone charge waivers for reasons such as business disruption due to construction.

Stronger internal controls involving cash and other assets—The Lottery has improved internal controls related to its cash-handling practices, vault balances in its claims stores, and revolving fund,

and instituted regular checks of employee payroll transactions, as recommended in the 1997 performance audit. Improvements include the following:

- **Reviews of cash reconciliations**—The 1997 performance audit found that the Lottery did not adequately segregate cash-handling duties at its Phoenix and Tucson claim stores. These stores, located inside Lottery offices, sell instant and online lottery tickets and redeem winning tickets. Now, although store employees continue to perform store cash reconciliations, other Lottery employees review these reconciliations each day.

Photo 2:

Lottery Claim Store



Lottery claim stores sell Lottery tickets and redeem prizes.

- **Reduced cash balances**—The 1997 audit found that the claim stores maintained excessive daily cash balances at the Phoenix location. Although auditors again found high cash balances during this audit, the Lottery has since reduced the cash balances to a level sufficient to pay instant-ticket winners. The Lottery now monitors its cash levels and pays winners by cash or by check, depending on the amount of cash available.
- **New revolving fund controls**—In 1997, the Lottery’s revolving fund contained excessive balances and lacked documentation of expenditures. The Lottery has now reduced the balance from a maximum of \$30,000 to approximately \$2,500, and upper management must approve all revolving fund expenditures before they are made.
- **Payroll transaction checks**—The 1997 audit found that the Lottery’s payroll and internal audit departments did not periodically check calculations of employee wages and associated deductions. Now, the Lottery’s accounting supervisor regularly reviews employee payroll transactions. In addition, auditors’ examination of the Lottery’s current payroll procedures

and payroll documents indicates that the Lottery has established effective payroll transaction checks.

Cash-handling controls have improved.

Contract and procurement oversight is stronger—The Lottery appears to have strengthened its contract oversight and procurement practices since a 1995 Auditor General special financial audit (see *Arizona Lottery: Report on Special Review, April-October 1995*), and the 1997 performance audit, which determined that many of the issues identified in 1995 had not been corrected. The 1995 audit found that the Lottery did not provide adequate oversight over its advertising vendor. For example, the audit reported that the Lottery lacked adequate procedures to oversee its \$8 million advertising contract and did not perform vendor compliance reviews. Actions taken since that time include:

- **Addition of a procurement manager**—In 2000, the Lottery hired a procurement manager experienced in Arizona state procurement and contract management. This employee works closely with Lottery management and the State Procurement Office to develop requests for proposals and review bids for new contracts.
- **Development of contract oversight procedures**—In 2001, the Lottery instituted a new contract oversight policy, which established procedures for monitoring advertising, instant-ticket printing, and online service contracts.

Additional security controls and resources for information technology—Finally, the Lottery has addressed concerns raised in the 1997 performance audit regarding computer system resources, computer security controls, and information technology policies. Actions taken include:

- **Increased computer system resources**—The 1997 audit found that the Lottery had inadequate computer resources to support its games. For example, although state lotteries that participate in the multi-state PowerBall game must have a backup processor, the Lottery had only one high-speed computer data line between the office and its contractor, and only one mainframe processor with no backup equipment in case of breakdown. The Lottery now has two data lines and four processors.

- **Employee access controls**—The 1997 audit reported that employees had inappropriate access to data files that could be deleted or manipulated, which increased the potential for fraud and abuse. Now, the Lottery has an access control list that limits employee access to the computer system according to position and need. In addition, the Lottery has instituted an electronic access control to keep unauthorized personnel from entering the information technology area, and has erected physical barriers such as doors and walls to enclose this area.

- **Progress in developing information technology policies**—The 1997 audit found that the Lottery lacked written procedures regarding computer systems and information technology. For example, audit staff noted a general lack of policies and procedures regarding computer basics, such as security, operations, and system failures, and also noted that software program instruction and problem-solving manuals had not been maintained. The Lottery has since begun to develop its internal procedures in these areas, although they are not yet complete.

The Lottery Can Further Improve Its Control Procedures

The Lottery should take additional steps to improve its internal controls. First, the Lottery should revise its procedures for distributing monies to state programs to ensure that the order of distribution is consistent with statutes. In addition, the Lottery should develop some new accounting procedures to cover Lottery-specific transactions.

Complying with statutory requirements for distributing monies to certain beneficiary programs—The Lottery has not updated its distribution procedures since state statutes were amended in 1997, and, as a result, has been incorrectly distributing revenues from two games. The incorrect distribution involves payments to four Funds—Local Transportation Assistance Fund (LTAf), the County Assistance Fund, the State Heritage Fund, and the Clean Air Fund. Currently, the Lottery incorrectly pays revenues from its 3-number online game and bingo-themed instant-ticket game to LTAf and the County Assistance Fund, until they have received their statutorily allowed amounts, and

only then begins to distribute these game revenues to the State Heritage Fund. Although the total amount transferred to each fund is the same as if the Lottery followed the statute, the Lottery's practice delays payments to the State Heritage Fund until late in the fiscal year. In fiscal year 2001, the Lottery did not begin paying the State Heritage Fund until March.

Statutes specify the conditions for distributing monies to the State Heritage Fund. A.R.S. §5-522(D) directs the Lottery to distribute up to \$20 million to the State Heritage Fund from any monies remaining in the Lottery Fund after operating expenses have been paid and the LTAF and County Assistance Fund have received their full allowed amounts. These monies derive from The Pick, Fantasy 5, and instant-ticket games. However, according to statutory amendments approved in 1997, A.R.S. §5-522(A)(4) requires the Lottery Director to determine whether the State Heritage Fund will receive its full allowed amount for the year. If he determines that it will not, the 1997 amendments require the Lottery to pay (1) 29 percent of 3-number online game revenues and (2) 21.5 percent of revenues from a bingo-themed instant ticket game to the State Heritage Fund. These revenues go to the Clean Air Fund if the State Heritage Fund has already received its fully allowed amount.

The Lottery should correct its procedures to follow the order specified in statutes.

Improving accounting procedures—Finally, the Lottery should adopt additional written procedures to cover Lottery-specific accounting functions. Lottery officials state that they follow procedures prescribed in its existing accounting manual and the *State Accounting Manual*. However, these current resources are not comprehensive because they lack written procedures for accounting functions that are unique to the Lottery, such as automated weekly revenue collections from retailers.

Recommendations

1. The Lottery should directly distribute revenues from the 3-number online game and the bingo-themed instant-ticket game to the Heritage Fund consistent with statutory requirements.
2. The Lottery should supplement its *State Accounting Manual*-based procedures with additional accounting procedures for lottery-specific transactions, such as automated weekly revenue collections from retailers.

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SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2951, the Legislature should consider the following 12 factors in determining whether the Arizona State Lottery Commission should be continued or terminated.

1. The objective and purpose in establishing the Lottery.

The Arizona State Lottery Commission was proposed by initiative petition and approved by voters in the November 1980 general election. Voters again approved the Lottery in the November 1998 election, after the Legislature referred the issue to the voters. The 1998 voter-approved measure extends the Arizona State Lottery Commission through July 1, 2003.

According to A.R.S. §5-504(B), the Lottery Commission's statutory purpose is:

“to oversee a state lottery to produce the maximum amount of net revenue consonant with the dignity of the State.”

The Lottery attempts to meet its statutory mission by administering instant-ticket and online games in order to generate revenues for the State General Fund, and various state programs.

The agency mission statement is,

“To support Arizona programs for the public benefit by maximizing revenue in a responsible manner.”

Although the primary objective of maximizing revenue for state programs has not changed, the Lottery's strategic plan for fiscal years 2002-2004 also emphasizes corporate citizenship, which includes the promotion of responsible gaming. The Lottery's strategic issues consist of support for public programs, corporate citizenship, and organizational efficiency.

2. The effectiveness with which the Lottery has met its objective and purpose and the efficiency with which it has operated.

Since its inception in 1981, the Lottery has generated approximately \$4.1 billion in revenues, returned more than \$1.4 billion in net revenue to support the State General Fund and other state programs, and awarded more than \$2.7 billion in prizes. Since the 1997 performance audit, the Lottery has demonstrated operational improvements. Specifically, the Lottery:

- **Maintained low administrative costs**—Since the 1997 performance audit and Sunset review, the Lottery has consistently kept its administrative costs within the statutory allowable limit of 18.5 percent of total revenues, which includes sales revenue, retailer license fees, and investment income. Operating expenses as a percentage of total revenues were 16.3 percent in fiscal year 2001.
- **Improved management practices and internal controls**—The Lottery has made considerable progress in implementing 1997 performance audit recommendations to improve agency management practices, internal and management controls, contract oversight, and information technology resources. For example, it has improved its oversight of the Lottery retailer network, and strengthened controls related to cash handling, and improved computer security. (See Finding III, pages 31 through 37.)

In addition to maintaining these improvements, the Department should take a number of steps to further enhance its effectiveness. First, the Lottery should consider additional options to increase ticket sales revenues, and the net sales revenue distributed to state programs. Although the Lottery has implemented all but one of the 1997 audit recommendations to increase sales, decreased online ticket sales have offset most of the increase in instant-ticket sales. The decline in online sales, coupled with an increase in the percentage of Lottery revenues being paid out in prizes, has lowered revenues for programs that depend on the Lottery for funding, such as the

State Heritage Fund. Some state programs, such as the Clean Air Fund and Healthy Arizona programs, have never received funding from net game revenues. In order for all programs to receive funding, the Lottery would need to generate from between \$422.8 million and nearly \$593 million. Some options that the Lottery should implement to further increase sales include expanding use of Instant-Ticket Vending Machines (ITVMs), implementing new ticket types, such as “pull-tabs,” using sales staff more effectively, and expanding its retailer incentive program. (See Finding I, pages 15 through 24.)

The Lottery should also take steps to improve the new compliance inspection program that it enhanced in 2000 to improve retailer oversight. Specifically, the Lottery should develop a plan to select which retailers will undergo inspections and incorporate tracking procedures into the program. In addition, the Lottery should develop a plan to improve enforcement of the Lottery’s underage wagering rules and laws. (See Finding II, pages 25 through 29.)

Finally, in addition to improvements in agency management practices, the Lottery can make further improvements. Specifically, it can further improve accounting procedures and improve controls over sports-themed noncash prizes. In addition, it should follow statutory requirements for distributing monies to state programs. (See Finding III, pages 31 through 37.)

3. The extent to which the Lottery has operated within the public interest.

The Lottery has taken several steps to better serve the public interest. Determining the extent to which the Lottery operates within the public interest depends on individual beliefs regarding public-sponsored gambling. Proponents argue that the Lottery has operated within the public interest by generating substantial net revenues that are apportioned to a variety of designated state funds and programs. In contrast, critics maintain that the Lottery is a form of state-sponsored and state-advertised gambling. Such critics maintain that the social costs asso-

ciated with raising such revenue are unknown, and may in fact exceed the public benefit gained from Lottery sales.

Since the 1997 audit, the Lottery has introduced public awareness campaigns to improve the public perception of the Lottery, educate the public about the programs supported by Lottery proceeds, and increase the visibility of winners. New programs include the Lottery's "Where the Money Goes" campaign, and its "Winner Awareness" program. The Lottery also tracks public opinion and perception regarding various Lottery issues through monthly surveys. Further, the Arizona Lottery oversees a Compulsive Gambling Treatment and Information program that the State Legislature approved in 1999, as provided in the General Appropriation Act, Laws 1999, Chapter 1, 1st Special Session. Beginning in 2000, the State required the Lottery to administer this program. By state law, 50 percent of the appropriation must be used to support a compulsive gambling toll-free crisis hotline, and 50 percent must be used to contract for compulsive gambling treatment programs. The Legislature appropriated \$500,000 in fiscal years 2000 and 2001. The Lottery contracts with the Arizona Department of Health Services to administer treatment services.

4. The extent to which rules and regulations promulgated by the Lottery are consistent with the legislative mandate.

The Lottery has made most, but not all, of the rules required of it. The Lottery director's general rule-making authority is stated in A.R.S. §5-504(B).¹ As reported in a review conducted by the Governor's Regulatory Review Council, at the request of the Auditor General's Office, the Lottery should adopt rules in four areas.

¹ Under A.R.S. §§41-1044 and 41-1057, rules that relate to the design, operation, or prize structure of a lottery game are reviewed and approved by the Attorney General's Office, rather than the Governor's Regulatory Review Council.

- First, the Lottery should develop rules pertaining to the two special economic development games that it offers each year as required by A.R.S. §5-504(H).
- Second, as required under A.R.S. §5-513(A)(3)(c), the Lottery should adopt rules to determine the fees associated with processing the voluntary assignment of a Lottery prize, such as an annuity, to another party. According to state statute, Lottery prize winners may assign a Lottery prize to another party, under specific circumstances.
- Third, the Lottery needs to adopt rules related to its liability setoff program, as required under A.R.S. §5-525(A). Under this program, Lottery prize payments are used to satisfy debts that a person owes to the State. Currently, the Lottery receives data from the Arizona Department of Economic Security, Arizona's county courts, and Northern Arizona University.
- Finally, the Lottery should adopt personnel rules for sales personnel who deliver products, as required under A.R.S. §5-504(E). This statute, which became effective July 1, 1997, states that Lottery personnel who handle its products are not covered by the State's personnel system. The law applies only to sales personnel hired after the law's effective date. Four of the Lottery's 23 representatives were hired after the law became effective. Despite the law, Lottery officials contend that all sales representatives remain "covered positions." Since this contention conflicts with the law, the Lottery should promulgate rules to provide sales personnel hired after the law changed with the same protections afforded by the personnel system or request that the Legislature change the law to not exempt sales personnel from the State's personnel system.

In addition, GRRC identified a problem with Lottery rules pertaining to license fees. Currently, Lottery rules state that retailer license application fees are nonrefundable. However, A.R.S. §41-1077 provides that if any agency does not send to the applicant a written notice

granting or denying a license application within the applicable time frame, the agency must refund all fees charged for reviewing and acting on the application. The Lottery should amend its license application rules to conform to state statute. The Lottery is currently undergoing its 5-year rules review. As part of this process, the Lottery intends to adopt the required rules, and amend its license application rules, as recommended by GRRC.

5. The extent to which the Lottery has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public.

The Lottery has actively encouraged input from the public before promulgating rules and regulations. Proposed rules are summarized in the Administrative Register, and any proposed rule is placed on a regular Commission meeting agenda for consideration. Commission meeting notices are posted at both the Phoenix and Tucson Lottery offices. The Lottery also notifies industry and retailer representatives of proposed rules and regulations that could affect them. In September 2000, the Lottery formed a Retailer Advisory Committee to review, evaluate, and recommend revisions to retailer rules. Typical discussion issues include license qualifications, minimum sales requirements, and license suspension/revocation procedures.

Finally, the Lottery also maintains a Web site to inform the public of its activities. Some of the information posted includes information on the most recent online drawings and the status of active instant-ticket games.

6. The extent to which the agency has been able to investigate and resolve complaints that are within its jurisdiction.

The Lottery receives and responds to a variety of informal complaints from both retailers and the public.

Common grievances may include complaints about Lottery terminals, retailers, and fraud and stolen tickets. The Lottery assigns the complaints to appropriate personnel, such as the Security Division investigators, for further research and disposition. Actions taken may include filing criminal complaints with law enforcement agencies and suspending or revoking retailer licenses.

7. The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under enabling legislation.

A.R.S. §5-512.01 provides the Attorney General and county attorneys concurrent prosecution authority for an offense arising out of or in connection with the formation, management, operation, or conduct of the State Lottery. For example, the Lottery has worked with Mohave County law enforcement officials to investigate and prosecute a case involving ticket theft and embezzlement that took place over a 3-year period.

8. The extent to which the agency has addressed deficiencies in the enabling statutes which prevent it from fulfilling its statutory mandate.

The Lottery has supported several changes to statutes that were amended in the 2000 Legislative Session. For example, A.R.S. §5-504(J) prohibits online or electronic keno games or any Internet games. Subsection (K) also requires the Lottery to print on each lottery ticket a statement that help is available if a person has a gambling problem, and a telephone number to call for assistance. A.R.S. §5-506(10) states that the Lottery has 30 days after receiving an allegation that a retailer has violated state laws or rules to determine whether the retailer has violated the rule, or whether a criminal investigation is warranted. Finally, A.R.S. §5-515.01 makes it unlawful to sell a lottery ticket to a person who uses an electronic benefits card or public assistance voucher. A.R.S. §5-515.02 also makes it unlawful for a person under 21 years of age to purchase a lottery ticket, beginning on June 1, 2003.

9. **The extent to which changes are necessary in the laws of the agency to adequately comply with the factors listed in the sunset law.**

This audit did not identify any needed statutory changes.

10. **The extent to which the termination of the agency would significantly harm the public health, safety, or welfare.**

Terminating the Lottery would not have a detrimental effect on the public health, safety, or welfare. However, terminating the Lottery would eliminate a significant amount of revenue that has been made available to the State. The Arizona Lottery has transferred an average of \$70.6 million per year to the State since its inception.

A November 1998 ballot measure asked voters whether they wanted to eliminate the Lottery or extend it through July 1, 2003. Nearly 67 percent of voters approved extending the Lottery. According to the Arizona Attorney General, the decision to continue or terminate the Lottery beyond this date must either be determined by a super-majority of the Legislature (75 percent of both houses) or be referred to Arizona voters. On April 25, 2002, the Legislature referred the issue to the voters for consideration in the November 2002 election. The measure, if approved, would sunset the Lottery on July 1, 2012, and include the Lottery in the Legislature's regular sunset cycle process, thus discontinuing the need to refer the matter back to the voters.

11. **The extent to which the level of regulation exercised by the agency is appropriate and whether less or more stringent levels of regulation would be appropriate.**

The Lottery is not a regulatory agency. However, statute requires the Lottery to license lottery retailers, giving the retailers the right to sell online and instant lottery tickets. Some of the benefits associated with licensing retailers include conducting background checks to assess the character of potential retailers, and credit checks to assess

whether they pay their bills on time. Licensure also allows the Lottery to suspend or revoke retailers' ability to sell Lottery products if they fail to comply with Lottery rules, or do not meet minimum sales requirements.

12. The extent to which the agency has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.

The Arizona Lottery makes extensive use of private contractors in the performance of its duties. Private contractors are used for functions such as ticket printing; advertising; online game systems, services and tickets; annuities to fund grand prizes; advertising; sponsorships; and promotional materials. Private contractors also perform auditing functions, oversight of game drawings, and security monitoring. According to the Lottery, more than 86 percent of its fiscal year 2001 expenditures were outsourced. The Lottery will further privatize its functions after it contracts out the delivery of instant tickets, as recommended in the 1997 audit. The Lottery expects a contractor to complete implementation of this function by January 2003.

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APPENDIX

Arizona State Lottery Commission Funds and Programs Designated in State Statute To Receive Lottery Monies

- **State General Fund**—Currently limited to \$31 million of PowerBall revenues each fiscal year. Until fiscal year 2002, the limit on PowerBall revenues was \$21 million per year. The General Fund also received a one-time transfer from unclaimed lottery prizes in fiscal year 1999 and mandatory transfers from the Lottery’s Fund’s advertising budget in fiscal years 2000 and 2001. If all other beneficiary funds receive their statutory allotments, any remaining monies revert to the General Fund.
- **Local Transportation Assistance Fund**—Limited to a maximum of \$23 million each fiscal year from The Pick, Fantasy 5, and instant-ticket games. Used by Arizona cities and towns for transportation projects and a variety of other purposes. Up to 10 percent may be used for socio-cultural and arts programs if matched by private monies.
- **State Heritage Fund**—Limited to \$20 million each fiscal year from instant-ticket games and the online games, The Pick, Pick3, and Fantasy 5. Approved by voters in 1990 to support Arizona State Parks and Arizona Game and Fish Commission projects such as trail and park maintenance, land acquisition, and educational programs. Funding began in fiscal year 1991.
- **County Assistance Fund**—Limited to \$7.65 million each fiscal year from The Pick and Fantasy 5 online games, and instant-ticket games. The State’s 15 counties use Lottery monies for a variety of programs, such as law enforcement, education, and health.
- **Commerce and Economic Development Fund**—The Arizona Department of Commerce Economic Development

Commission receives proceeds from two instant-ticket games designated by the Arizona Lottery for economic development programs such as the “Main Street Program,” which supports rural Arizona downtown revitalization efforts. Funding began in fiscal year 1990.

- **Mass Transit Fund**—Limited to \$18 million each fiscal year from PowerBall, Pick3, and the Bingo instant ticket game. Established in 1995 as a second local transportation assistance fund to support public transit. Funding began in fiscal year 1998.
- **Healthy Arizona Programs**—Funded from online games of The Pick, Fantasy 5, Pick3, and instant-ticket games only after the Heritage Fund receives its annual \$20 million. Established in 1996 to provide Lottery monies to the Arizona Area Health Education System; Disease Control Research Fund; Healthy Families Pilot Program; Health Start Pilot Program; teenage pregnancy prevention programs; and the Women, Infants and Children Food Program.
- **Clean Air Fund**—Funded only after the Heritage Fund receives its annual \$20 million. Established in 1996 for the Arizona Department of Commerce to use for purposes such as grants promoting the use of alternative fuels and High Occupancy Vehicle signs on federal and state roads. The fund received a one-time transfer of \$500,000 from unclaimed prizes in fiscal year 1997.
- **Court-Appointed Special Advocates Fund**—Funded solely from 30 percent of the Lottery’s Unclaimed Prize Fund. Used to train over 900 Court-Appointed Special Advocates, who provide a voice in the courtroom for abused, neglected, and abandoned children. Funding began in fiscal year 1992.

AGENCY RESPONSE

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May 28, 2002

Ms. Debbie Davenport
Auditor General
Office of the Auditor General
2910 N. 44th St., #410
Phoenix, AZ 85018

Dear Ms. Davenport:

Thank you for conducting the performance audit of the Arizona Lottery. We appreciate the favorable overview and positive evaluation of the progress made since the last performance audit in 1997 and welcome the Auditor General's recommendations as the basis for continuing the successful strategies for the future of the organization.

The performance audit provides an excellent record of the status of the Lottery. Compared to the prior audit conducted five years ago, the Lottery has gone from a D+ grade up to an A- grade. This document will be an extremely useful resource for the following reasons:

- The audit identifies several significant improvements and initiatives that have been introduced during the past five years.
- The audit recognizes that some of the improvements and initiatives incorporated into the agency's operations may still require continuing support and attention.
- The audit recommends improvements and initiatives that can be presented to the State Legislature for support and funding for future implementation.
- The audit identifies improvements and initiatives that can be introduced as the Lottery enters a new era of growth and prosperity.

Ms. Debbie Davenport
May 28, 2002
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During the past five years, the Lottery has achieved a level of stability that reflects our commitment to responsible public management, sound business practices and professional marketing strategies. By adopting internal policies and procedures, preparing and implementing product strategic plans and conducting responsible advertising, the Lottery has maintained a consistent sales level, a respectable return to the State and an impressive measure of public trust and confidence. We pledge to continue the following:

- Operate the agency in an efficient and effective manner to responsibly maximize revenue to benefit State projects and programs.
- Help retailers, players, and the general public understand the need to be aware of the problem gambling and underage wagering issues.
- Increase the Lottery's positive visibility among players, retailers, employees, business leaders, the media, and the general public.
- Design, develop and manage ScratchersSM games to maintain the Lottery's most successful product for players' enjoyment.
- Enhance online games to achieve the "more winners, more often" objective.

By adhering to the above practices, we will retain the Arizona Lottery's place in the forefront of public performance for the people of Arizona.

Sincerely,

Geoffrey E. Gonsher
Executive Director

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INTRODUCTION

THE LOTTERY HAS MADE SIGNIFICANT PROGRESS SINCE 1997.

In 1997, the Lottery was receiving considerable negative attention because of the agency's management, game sales and retailer relations. Subsequently, Governor Jane Dee Hull took office and recognized questionable practices within the agency, terminated the executive director and charged the new management team with the responsibility to reestablish the Lottery's credibility.

Our immediate impression was that the Lottery was an agency in transition. We needed to return to a professional management track and to make responsible marketing, advertising and sales decisions. We also needed to revitalize our games and halt the trend of declining sales. Expanded gaming competition, greater player boredom, and unexciting games were contributing to an environment in which regular Lottery players were buying fewer tickets less often and occasional Lottery players were buying tickets only when jackpots were high.

In addition, we were confronted with the Auditor General's performance audit that identified deficiencies in the way the Lottery as a public entity managed its games, retailers and operations. This performance audit was a wake-up call to the Lottery, telling us in no uncertain terms that the manner in which the Lottery had been conducting business was no longer acceptable or appropriate to achieve the agency's statutory objectives.

It was obvious that we could no longer hope for success and continue to do business as we had in the past. We could no longer rely upon stale, out-of-date marketing approaches. And we could no longer assume that people would buy our products just because the games were in the dispenser. This environment motivated us to do a better job with our products and our customers and challenged us to remain a dependable source of revenue for the State of Arizona.

This year's audit and the Lottery's response describe the progress we have made since 1997. We have restructured our games to appeal to a wide variety of players and, as a result, have met or exceeded our sales goals, thereby generating financial support for our statutory beneficiaries.

Further, we have stabilized the agency's management. We have improved and strengthened our public image. We have taken the initiative to be an accountable, productive and responsible public agency. In the performance audit and in this audit response, you will read about the policies, practices, and philosophies that serve as the basis for how the Lottery conducts business today for the people of Arizona.

THE LOTTERY CONDUCTS ITSELF AS A BUSINESS ENTERPRISE.

The Arizona Lottery is a state entity in a business environment. But because the Lottery is a government agency, it is not widely viewed as a business. This is unfortunate because the Lottery must conduct itself as a private sector business in order to be successful.

The Lottery is similar to major corporations in that it designs, manufactures, distributes and sells consumer products in the retail market. The Lottery's sales are achieved with low administrative overhead costs, which reflects the Lottery's achievement of 86% privatization with a reliance upon an extensive group of contractors to provide services.

Structured as a public entity, the Lottery is obligated to conduct business consistent with statutory requirements. This includes fiscal, personnel, procurement, operations and several other areas of policy and practice. One of our objectives has been to incorporate private sector concepts, practices, and policies into both our day-to-day and long-term operations.

We have achieved this objective by including individuals who have private-sector experience in the decision-making process. Representatives from local businesses, other lotteries and major government organizations have participated in procurement evaluation panels. Members of the business and professional community are serving on the Retailer Advisory and the Responsible Gambling Advisory Committees. And individuals with private sector experience have participated on several job interview panels. Their perspectives have enabled us to introduce new, different and effective management principles and practices to balance our internal focus.

The Arizona Lottery is truly a corporate organization existing in a governmental structure. Private sector businesses have stockholders, boards of directors and customers. Similarly, the Arizona Lottery has stockholders (the people of Arizona), a regulatory body (the Arizona Legislature), a Chairman of the Board (the Governor) and customers (players and retailers).

It is for all these reasons that the Arizona Lottery makes every effort to conduct itself as a business while still respecting the mandates of government. We prepare annual budgets, develop strategic plans, conduct sales and marketing campaigns, perform customer research, design new products and promotions, track industry trends, support a retail distribution network and contribute to the community. These activities are essential if we are to remain a successful member of the Arizona business community.

RESPONSIBLE STRATEGIC ISSUES ARE EMPHASIZED.

The Lottery's strategic issues stress statutory requirements to generate revenue for the State of Arizona. In addition, the issues respond to our commitment to operate in an efficient and effective manner and outline our continual efforts to promote the Lottery as a responsible corporate organization.

Consistent with our continuing improvements, the Lottery's Strategic Plan incorporates the following:

- Mission Statement. The mission statement emphasizes greater support for Arizona programs in a responsible manner.
- Strategic Issues. The strategic issues include support for public programs, corporate citizenship and organizational efficiency.
- Goals and Performance. The performance measures for the agency goals address the strategic issues by promoting responsible gaming, pursuing corporate and community partnerships and expanding public awareness of the Lottery's benefits to the people of Arizona.

SALES AND PERFORMANCE

RESULTS HAVE EXCEEDED EXPECTATIONS.

Over the past few years, the Lottery's sales projections have been established at a realistic, conservative level because of the State's political environment, increasing competition, and unpredictable jackpot levels. The success of our efforts, however, has resulted in the Lottery exceeding the sales forecast for the past four years.

Sales

- The Lottery completed the best four years in its 20-year history with total revenue over \$1 billion.
- In FY 01, total sales were nearly \$273 million, marking the first time in the history of the Lottery that sales exceeded a quarter of a billion dollars for four consecutive years.
- FY 02 total sales are projected to reach \$290 million, a record high in the Lottery's 20-year history.
- Instant ticket sales reached an all-time high of \$136.9 million in FY 01, an increase of 30% since 1997.

Winning Tickets and Prizes

- Players had 16.9 million more winning tickets for Lottery games during the past four years compared to the prior four-year period.
- Players won \$228.8 million in prizes in FY 01, \$96 million more than the prior year.

Retailer Benefits

- Retailers received an additional \$5.8 million in commissions during the past four years compared to the prior four-year period.
- Retailer commissions of \$18.5 million (an all-time high) were \$1.7 million, or 10% more than the prior year.

SCRATCHERS GAMES ARE AN AWARD-WINNING SUCCESS STORY.

The evolution of the Lottery's Scratchers product over the past four years has been one of our best success stories. Sales for these games culminated in an all-time high of \$136.9 million in FY 01. This success is a direct result of our focused attention on the management of the product design and development. It has included player research, ticket design, printing levels, balanced product mix, attractive prize payouts, retailer placement and games that are appropriate for the Arizona market. Our original goal was to increase product sales, and we achieved it beyond our expectations.

Several new Scratchers policies have been implemented to support the increase in sales. New game concepts have replaced overused, outdated themes. Tickets are now larger with enhanced graphics and larger fonts for easier readability. We decreased the quantity of tickets printed per game depending on theme and prize, thereby creating opportunities to offer new games more often. The top prize for \$1 games has been lowered to \$250 - \$1,000 in many games to fund more meaningful mid-tier prizes and provide more players with a winning experience. The \$2, \$3, \$5 and extended-play games, which continue to be popular with players, are a substantive part of our product mix. All of these improvements have been recognized and appreciated by players, as evidenced by the record sales.

The Lottery's Scratchers strategy incorporates the following objectives to increase players' enjoyment of the games:

- Continue to introduce popular games and themes at regular intervals to provide fresh excitement for the players.
- Offer a balanced mix of \$1, \$2 and \$5 tickets, player-supported themes and extended-play games.
- Introduce new \$3 and \$5 games in response to player enthusiasm and retailer appreciation.
- Provide a competitive prize payout that guarantees the State the statutory distribution, compares favorably to the payout in the industry and sustains the number of meaningful mid-tier prizes.
- Design attractive and appealing game graphics that are easy to read and understand.

This strategy reinforces the product initiatives introduced in 1997 and has become a model for current and future decisions. The Lottery now has an analytical trend basis, substantial data and sales results upon which future Arizona Lottery management can make informed decisions. The ultimate objective of the strategy is to continue to improve the management of the agency's instant ticket product to increase sales for greater revenue for the State of Arizona.

CHANGES TO ONLINE GAMES HAVE BEEN MADE, BUT COMPETITION AND OTHER FACTORS HAVE IMPACTED SALES.

Prior to 1997, no positive changes had been made to the Lottery's online products for several years. Consequently, sales were decreasing at a steady pace.

In our first message to the Legislature five years ago, we proposed changes to the games that included new matrices, higher jackpots, more winners and more popular games. Since that time, structural improvements have been introduced to the Arizona-based online games, The PickTM, Fantasy 5TM and Pick 3TM.

The purpose of the Lottery's online strategy is to continue providing creative, sales and management support to the Lottery's online games to maximize sales for greater revenue for the State of Arizona. The online strategy includes the following objectives:

- Provide a prize payout that protects the required distribution to the State, sustains the number of meaningful mid-tier prizes, promotes increased sales and remains competitive with industry standards.
- Balance the results of Arizona-specific player research against industry trends in the development and modification of games.
- Optimize existing games to maintain their appeal in an ever-changing entertainment environment.
- Ensure that online game players can clearly understand game play styles, options and prize structures so responsible purchases are made by informed customers.

Despite these efforts, the Lottery's online games are still suffering. Every recommendation included in the 1997 audit has been introduced, but, as noted by the recent audit, factors outside the Lottery's control have negatively impacted online sales.

An audit-noted factor is the dramatic increase in competition from the Indian casinos. The audit also noted that the major games are jackpot driven. The Pick players do not buy tickets until the jackpot increases substantially. Powerball® sales do not increase measurably until the jackpot hits \$70 million or above. A third contributing factor was the legislative reduction in advertising funds by 30%, which severely limited the Lottery's ability to market these games.

In FY 03, the Lottery plans additional changes to The Pick and Fantasy 5 in another effort to rejuvenate these games for greater player appeal and increased revenue. In addition, a new corporate sponsor for Pick 3 will provide advertising and marketing support that the Lottery cannot afford today.

MARKETING AND ADVERTISING ARE CONDUCTED IN A PROFESSIONAL MANNER.

Four years ago, the Lottery introduced a new strategic direction for all marketing and advertising activities. The primary focus in all public communications was to position the Lottery as a responsible corporate citizen with professional business practices. These themes are now the nucleus of all marketing and advertising activities.

The Lottery will continue these themes as they have been so well received and have positively impacted both the organization's public image and sales. The focus is to reinforce the Lottery's reputation among players and the general public, to raise awareness of how game proceeds are distributed and to increase the visibility of winners. The marketing strategy incorporates these elements into the following objectives:

- Conduct all advertising in a responsible manner.
- Design advertising to appeal primarily to regular and occasional players.
- Promote the beneficiaries of Lottery game proceeds.
- Provide jackpot information for Powerball and The Pick to maximize sales.

- Promote premium Scratchers games that appeal to a variety of players to continue the strong growth pattern.
- Conduct player research to develop game concepts responsive to player interest and to measure public perceptions and attitudes.

Our commitment to responsible advertising is not to entice players to spend their money on fantasies, dreams and high expectations. Nor will players be barraged with obnoxious characters, seductive temptations or confusing messages. The Lottery's approach to all player and public communications will continue to be clear, responsible, professional and informative.

The Lottery's marketing strategy continues to move the Arizona Lottery into a new era of public communications. With fewer financial resources available, the Lottery must leverage the campaigns' investments wherever possible to achieve maximum impact. It is critical to reinforce the commitment that the Arizona Lottery has already made to responsible advertising and marketing standards.

COMMUNICATIONS HAVE IMPROVED VISIBILITY AND PUBLIC IMAGE

The Arizona Lottery actually has two products to position and promote. The first, and most obvious, includes all of the online and Scratchers games that generate revenue for public programs and projects. The second, and equally important, is the image of our business. The Lottery has strategies and activities for supporting both of these products.

The Communications strategy has two components, one for internal communications and one for external communications. During the past few years, we have devoted substantial resources to support the external constituencies, including players, retailers, media and the general public. We conduct monthly research to track public opinions and attitudes toward the Lottery. The latest survey shows 78% of the public believes that the agency is run with honesty and with integrity. An independent retailer survey concluded that retailers "overwhelmingly had positive comments and opinions regarding services they are receiving from the Lottery." These are impressive indicators of a positive public and customer image.

We are just as proud of our efforts to strengthen internal relationships with our employees. The recent Employee Satisfaction Survey conducted by the State of Arizona revealed that a high percentage of Lottery employees expressed satisfaction with their jobs, with internal communications and with their work environment. The agency ratings were higher than the previous year and higher than the statewide average. For the third consecutive year, the Lottery enjoyed a favorably rating. It is encouraging to see that our communications efforts are succeeding among our employees as well.

We are pleased to have achieved several of the Lottery's communications objectives for players, retailers, employees, the general public and the media. The following are the Communications objectives:

- Reinforce general public communications by continuing the highly successful "Where The Money Goes" campaign.
- Improve retailer communications with a quarterly newsletter, game announcements and flyers announcing store-specific winners.

- Strengthen media relations by continuing to develop relationships with key media throughout the State and increased visibility and exposure in rural communities.
- Enhance employee communications by distributing a monthly employee newsletter, maintaining agency policies, participating in employee surveys and supporting recognition awards activities.
- Expand player communications with an updated and enhanced Web site, prompt response to player feedback, increased player hotline capacity, informative lobby displays, winner awareness program, and responsible gambling program and educational brochures.

The Communications strategies have increased the Lottery's positive visibility and image among players, retailers, employees, business leaders, the media and the general public.

SEVERAL HONORS AND AWARDS HAVE BEEN RECEIVED.

The Lottery has been honored to receive public recognition of its successes during the past few years.

- A recipient of the Governor's Spirit of Excellence Award for three consecutive years (Reduction of Outstanding Retailer Receivables; Game Development Team; and Scratchers: A Product Management Success Story).
- Selection of Cindy Esquer, Communications Manager, and Jeff Hoffman, Telecommunications Specialist, by the Arizona Administrators Association as the top two employees of the year in Arizona State government.
- The only lottery in the industry recognized by the American Gaming Association with the organization's first Communications Award for the Best Annual Report by a Public Agency.

SALES STRATEGIES HAVE RESULTED IN IMPROVED RETAILER RELATIONS AND PERFORMANCE IN THE MARKETPLACE.

The Lottery's sales objective is to generate the maximum amount of revenue in a responsible manner in order to support Arizona programs. To accomplish this objective, the Sales Department has developed a comprehensive action plan for the distribution, display and promotion of all Lottery products in the retail market.

Because the retail community is a critical component of our success, our sales strategies and guidelines strengthen this partnership. During the past four years, we have made the following progress within the retailer community:

- Communications. *Retailer Roundup* newsletter; Executive Director's letters regarding game enhancements, increased commissions, Problem Gambling Helpline information, underage wagering and public assistance voucher prohibition; Sales Director's letters regarding game changes, promotional opportunities and retailer incentives; winning ticket flyers; and jackpot alert plan.

- Participation. Retailer Advisory Committee, Playcenter RFP Evaluation Panel, General Market Advertising RFP Evaluation Panel, Lottery job interview panels, Arizona Food Marketing Alliance Partnership, Promotions Team and Economic Development Road Trip.
- Improved Operations. New online system with greater retailer reliability and flexibility of operations, policies for low-volume locations and partial pack returns.
- Security. Three-digit validation code, tracking ticket stock by retailer, enhanced password options, retailer loss prevention seminars, and routine compliance inspections.
- Training. Online Terminal Training Manual, training terminals at corporate sites, new equipment training, and Sales Representatives Training Program.
- Bonus Opportunities. Incentive bonuses for the relaunch of The Pick, Fantasy 5 and Pick 3, and new Retailer Incentive Plan.
- Promotional Support. Lottery promotions van, in-store promotions, industry-specific point-of-sale items and expanded line of point-of-sale items.

GAME PROCEEDS CONTINUE TO SUPPORT STATUTORY BENEFICIARIES.

Lottery game proceeds are distributed annually based upon statute. As a result of the strong sales in FY 01, three of the five major statutory beneficiaries received the maximum distribution. The Local Transportation Assistance Fund, County Assistance Fund, and the General Fund have consistently received the maximum distribution allowed. In FY 01, the Heritage Fund also received an increase of \$774,900, nearly 5% over the prior year. In addition, the Commerce and Economic Development Fund received \$3.17 million, almost 34% more than the prior year. Distribution from unclaimed prize monies to support the Court Appointed Special Advocate (CASA) Program was \$1.5 million.

Powerball® proceeds are designated for the General Fund and Mass Transit. Heritage Fund monies come from four games (Scratchers, The Pick, Fantasy 5 and Pick 3) that are shared among several beneficiaries. Prior to FY 98, the Lottery was required to return 31.5% of Scratchers sales and 31.5% of online sales to the State. After FY 98, the required return to the State was reduced to 21.5% for Scratchers and 29% for on-line games. The Powerball percentage was increased to 31.6% in FY 00. This adjustment has enabled the Lottery to use the additional funds for higher prize payouts for Scratchers games with a resulting increase in Scratchers sales including an all-time high in both FY 00 and again in FY 01.

PLAYER RESEARCH IS INCORPORATED INTO POLICIES AND DECISIONS.

Player research is a very important part of the Arizona Lottery’s decision-making process. A corporation the size of the Lottery cannot make arbitrary decisions regarding products and concepts without taking into consideration what is on the customers’ minds. It is important to know what they like and dislike, what motivates or influences them to buy, what perceptions or opinions they have about the company and products.

For this reason, the Lottery conducts several research projects on a regular basis. We have asked our players about their perception of the agency, advertising concepts, new game ideas, drawing broadcast issues, winning number information, etc. This input has become an integral part of our game design and public communications.

In FY 01, the research revealed the following:

Honesty and Integrity. More than 75% of Arizona adults who expressed an opinion agreed that “The Arizona Lottery is run honestly and with integrity.”

Beneficiary Knowledge. An average of 66% of Arizona adults believes the Lottery is an important way to raise money for the State.

Level of Play. Approximately 54% of Arizona adults have played Arizona Lottery games within the past year.

Spending Habits. Nearly three in five Lottery players (57%) say they spend \$2 or less per week on Lottery games.

Player Demographics. Typical players are slightly more likely to be male (51%), 47 years of age, and college-educated. Their average annual household income is \$45,650.

Minority Play. The ethnic breakdown of Lottery players is consistent with Arizona adult demographics.

SECURITY AND INTEGRITY

THE LOTTERY’S SECURITY PROTECTS PLAYERS, RETAILERS, EMPLOYEES AND THE GENERAL PUBLIC.

For the first time in the 20-year history of the Lottery, we have prepared a comprehensive strategy for achieving the organization’s security objectives. Previously, our Security Department was structured as a reactive unit to respond to needs and incidents as they occurred. The Security Department has grown to become a proactive unit that protects our players, retailers, employees and the general public.

The following recent accomplishments remain the basis for continuing the Lottery’s inspection, compliance, education and enforcement objectives:

- Established a full force of professionally trained law enforcement investigators to conduct compliance inspections, pursue violations, provide retailer loss prevention training and ensure drawing and game integrity.
- Created a new Security Compliance Policy with a structured inspection procedure that Lottery investigators follow to ensure compliance with laws, rules and regulations, and agency policies and procedures.

- Conducted all game drawings in a structured, secure manner to protect the integrity of the process.
- Managed an experienced Licensing Unit to ensure retailers are in full compliance with all legal, fiscal and operational requirements prior to licensing.
- Provided an initial educational approach to compliance inspections to ensure that retailers are knowledgeable and aware of all statutory and rule requirements.
- Involved retailer representatives in all compliance activities conducted on store property to ensure their knowledge and awareness of the Lottery's inspections.
- Established a structured inspection procedure that reinforces the Lottery's commitment to prevent underage wagering.
- Managed a fair and effective Low-Volume Retailer Program to ensure compliance with quarterly sales requirements and to support a cost-effective retailer network.
- Conducted investigations in conjunction with local and county law enforcement officials to prosecute violators.

We are proud of the professionalism that has been incorporated into the Lottery's security operations. Recent programs have enhanced the Lottery's ability to provide training to retailers, respond to complaints, investigate violations, and support loss prevention programs to protect retailers, customers and the integrity of the Lottery.

INFORMATION TECHNOLOGY CONTINUES TO IMPROVE EFFICIENCY AND RELIABILITY.

The Lottery's Information Technology strategies ensure that present and future technological needs of employees, retailers and players are met.

The Government Information Technology Agency (GITA) requires all state agencies to demonstrate through the strategic planning process that statewide technology standards are followed. All of the Lottery's annual strategic plans have been approved for implementation. The trends, issues, and goals identified in the reports set the stage for the Information Technology Division to be responsive to and supportive of our customers. The following goals are emphasized:

- Initiate the agency's computer hardware and software refresh project ensuring the technical environment can support current requirements.
- Continue updating a State mandated comprehensive Business Recovery Plan.
- Ensure current system availability goals are maintained and achieve 99% retailer uptime.
- Improve the internal sales reporting processes to provide more complete and timely data.
- Implement an intranet system to provide better internal communication.

In the last two years, our Information Technology staff has implemented over 100 projects including significant changes to three of our online games, Fantasy 5, Pick 3 and Powerball.

THE LOTTERY HAS TAKEN A LEADERSHIP ROLE IN RESPONSIBLE GAMBLING.

The Arizona Lottery acknowledges that problem gambling is an issue in this country. Various studies continue to show that the increase in gambling opportunities in every state has an impact on the situation. Problem gambling affects the gambler, the family and the community.

Lotteries, however, are generally recognized as a different form of gaming than that available at casinos, racetracks and off-track betting parlors. For most gamblers, the Lottery is not a typical venue of choice. In fact, the Texas Council on Problem and Compulsive Gambling has reported that the Lottery was cited as the primary gambling problem by only 3% of the callers to the Arizona helpline.

Nevertheless, the Arizona Lottery believes that the problem gambling issue is an important one and the State of Arizona should act responsibly in developing programs to help. The Arizona Lottery has taken a leadership role in the industry in the following ways:

- Introduced a formal Problem Gambling Program that includes public communications, free and confidential treatment services, a toll-free Helpline, and a public awareness and education program. The Helpline telephone number is available on all Lottery advertising, brochures, game play slips, tickets and other player communications.
- Testified in support of legislation to increase the Lottery wagering age from 18 to 21.
- Adopted a rule imposing civil penalties for selling Lottery tickets to a minor.
- Opposed Internet wagering and supported legislation to prohibit online gambling both in Arizona and on the national level.
- Supported legislation and adopted a rule that prohibits the use of welfare benefit cards to purchase Lottery tickets.

Since FY 99, the Legislature has appropriated \$500,000 annually for problem gambling referral, information and treatment services. With these funds, the Lottery has established an in-house center for the development, coordination and introduction of responsible gambling programs. The following were the FY 01 achievements:

- Established an Arizona Lottery Responsible Gambling Advisory Committee to provide guidance and suggestions for the development of problem gambling outreach programs.
- Introduced a new toll-free telephone number (877-921-4004) and changed the advertising message to emphasize “free and confidential help available.”
- Distributed 60,000 Lottery Problem Gambling brochures among 2,600 retailers and the Department of Health Services Regional Behavioral Health Authority offices and their subcontracted treatment providers.

- Created a Problem Gambling section on the Arizona Lottery's Website to emphasize education and information and provide links to other problem gambling sites.
- Continued the Interagency Services Agreement with the Arizona Department of Health Services to provide confidential, no-cost treatment services for those with gambling problems.
- Partnered with the Arizona Department of Corrections and the Arizona Council on Compulsive Gambling to provide problem gambling training for Department of Corrections staff who counsel inmates.
- Expanded the Helpline Referral System services to help both those who call the Helpline and those who contact the DHS treatment service providers directly.
- Launched a new print and broadcast media campaign to publicize the new toll-free telephone number and the availability of free and confidential treatment services.

Also included in the responsible gambling program is the issue of underage wagering. The Arizona Lottery is concerned about the perception that underage wagering is a problem in Arizona. Despite the lack of documentation or complaints about this issue locally, we continue to be proactive in our responsibility to the community. We have, therefore, taken several actions to be responsive to the underage wagering issue.

- Lottery sales representatives work closely with all retailers to determine an appropriate location for the placement of games. The location is in a central, visible spot, to provide oversight by store management, to increase the security of the operation of the machines and the transactions, and to still achieve the Arizona Lottery's sales objectives.
- Articles have been provided to local trade and general distribution publications regarding the underage wagering issue. Every opportunity is taken to provide information on this issue to our retail partners, our players and the general public.
- Additional "Please Play Responsibly" and "Must Be 18 Years or Older to Purchase Tickets" point-of-sale stickers have been placed in a visible area on all instant ticket vending machines.
- Personal letters were sent to all retail managers to identify the proper placement and display of games, to discuss the security of the vending machines and to emphasize the prevention of underage wagering.

After two years of providing the only comprehensive public responsible gambling program in Arizona, we are pleased with the results. An extensive media campaign has promoted the "Please Play Responsibly" message in several venues including all Lottery games, advertising and equipment. A toll-free telephone number has enabled hundreds of people in need to access information, referral and treatment for themselves, their families and their friends. And efforts to increase public education and retailer awareness of underage issues have resulted in no documented incidents. Progress has definitely been made, and we anticipate additional success in the future.

FINDINGS AND RECOMMENDATIONS

SALES

Recommendation 1. The Lottery should identify the number of retailers who would benefit from having an Instant-Ticket Vending Machine (ITVM), document the financial benefits expected from their utilization, and study the impact of leasing or purchasing ITVMs with varying numbers of ticket bins. It should then request authorization from the Legislature to use monies from the Lottery Fund for additional ITVMs.

Lottery Response 1. The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This recommendation is consistent with the Lottery's continuing sales and marketing strategy to introduce additional ITVMs in an effort to be more responsive to players, retailers, and beneficiaries. Unfortunately, the Lottery's two budget requests in 1998 and 2000 for additional ITVMs were not successful. We will again use the Auditor General's recommendations next year as the basis for requesting support from the Legislature to achieve this goal.

Recommendation 2. The Lottery should develop a plan to use pull-tab instant tickets to expand its retailer network and player base. The plan should be submitted to the Lottery Commission for its consideration.

Lottery Response 2. The finding of the Auditor General is agreed to and a different method of dealing with the findings will be implemented. The Arizona Lottery agrees that new products should be considered to expand the retailer network and player base. We have done so with the introduction of Pick 3, \$5 Scratchers tickets, and *Powerball - The Game Show™*. The pull-tab product has also been considered as a possible addition to the current game mix, but there may be policy implications of expanding gaming in Arizona into a new area. Although the experience of other states has shown that pull-tabs are a niche game that is popular in adult social establishments, we want to be sure that the introduction of the pull-tab product would not violate these important policies issues. There is a point of view that pull-tabs in adult social establishments would contribute to the expansion of gambling, and this perspective must be thoroughly discussed prior to pursuing the recommendation. The Arizona Lottery will continue discussing the recommendation with policy makers to ensure an appropriate course of action to be responsive to the Auditor General and consistent with public gaming policy.

Recommendation 3. The Lottery should follow through on its fiscal year 2003 plan to offer more \$3 and \$5 instant-ticket games and sell instant-ticket games at prices above its current \$5 tickets.

Lottery Response 3. The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This recommendation is consistent with the Lottery's continuing Scratchers strategy to design and develop higher priced games in response to player enthusiasm and retailer appreciation for the product. In recent years, the \$2, \$3, and \$5 games have become integral components of the annual plan. As a result, we have successfully set the stage for introducing a \$10 game in FY 03 and look forward to its popularity among players and retailers to generate revenue for beneficiaries.

Recommendation 4. The Lottery should (a) follow through with its plans to subcontract the delivery of instant tickets to retailers through its instant-ticket printing vendor and (b) ensure that such a delivery system includes the ability to track sales and calculate data that helps sales representatives assist retailers.

Lottery Response 4. The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This recommendation is consistent with the Lottery's continuing plan to introduce a new comprehensive Product Management System in January 2003. The system will include services to design and print Scratchers tickets, to inventory and deliver tickets to retailers, and to analyze and manage product placement and performance. The Product Management System will be the most extensive change to the way the Lottery conducts business in the past 20 years and will have a positive impact on personnel, sales and fund distribution.

Recommendation 5. Once it has the new ticket delivery system in place, the Lottery should restructure the duties of its sales representatives to include recruiting new retailers and providing sales support and training to current retailers.

Lottery Response 5. The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This recommendation is consistent with the Lottery's development of a Transitional Plan to introduce the Product Management System in January 2003. One of the objectives is to improve the effectiveness of the sales representatives in the retail market. This includes spending more time and attention in nurturing retailer relations, promotional activities, point-of-sale placement, employee training and retailer-specific sales analysis. We believe this approach will result in retailers doing a better job representing the Lottery in the marketplace.

Recommendation 6. To increase retailer sales efforts, the Lottery should continue its efforts to offer game-related retail incentives and expand its retailer incentive program with input from its retailer advisory committee and budget analyst. It should present its plan to the Lottery Commission for consideration.

Lottery Response 6. The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This recommendation is consistent with the Lottery's Retailer Incentive Plan introduced in January 2000 and several game-specific bonus programs. A total of 4,877 retailers have received a total of \$1.56 million in additional commission for meeting sales goals, conducting promotions and displaying point-of-sale materials established by the plan. A revised plan, approved by the Retailer Advisory Committee and the Lottery Commission, responds to the Joint Legislative Budget Committee's recommendation to develop a plan that focuses on comparative sales achievements. Bonus programs for The Pick and Fantasy 5 generated an additional \$75,000 for retailers.

SECURITY COMPLIANCE

Recommendation 1. The Lottery should improve the management compliance inspections by developing a systematic compliance inspection plan to present to the Commission for its approval.

Lottery Response 1. The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This recommendation is consistent with the Lottery's new Security Compliance Policy established in 2001. This is a structured inspection procedure that Lottery investigators follow to ensure

compliance with laws, rules and regulations, and agency policies and procedures. Because of limited personnel resources and other security responsibilities, the initial ambitious goals have not been achieved. A more realistic and manageable plan will be introduced in FY 03.

Recommendation 2. The Lottery should track compliance violations in a database and use it to enhance retailer training and education.

Lottery Response 2. The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This recommendation is consistent with the Lottery's desire to improve data management for the Security Compliance Program. As the program continues to evolve and we learn more about the priority areas for attention, a more comprehensive database of information about specific compliance issues will be beneficial.

Recommendation 3. The Lottery should develop a comprehensive program to monitor underage wagering for the Lottery Commission's consideration that includes the following components:

- a. Adding a question to its compliance checklist that directly addresses retailer knowledge of underage laws;
- b. Placing signs on its online terminals to remind retailers and players about age restrictions; and
- c. Adopting policies for retailer training similar to those that the Arizona Department of Liquor Licenses and Controls has established to enforce underage drinking laws. For example, the Lottery should train retailers to check identification on a regular basis, recognize invalid identification cards, and provide retailers with a list of acceptable identification cards.

Lottery Response 3. The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This recommendation is consistent with the Lottery's strong commitment to responsible gambling as reflected by the various programs that have been introduced since 1998. Despite the lack of documentation and complaints about the underage issue specifically, we continue to be proactive in our responsibility to the people of Arizona. Including the issue on the compliance investigation checklist, placing a sign on online terminals for retailers, and increasing retailer training will strengthen the Lottery's efforts in this area.

CONTROL PROCEDURES

Recommendation 1. The Lottery should directly distribute revenue from the 3-number online game and the bingo-themed instant ticket game to the Heritage Fund consistent with statutory requirements.

Lottery Response 1. The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This recommendation is consistent with the Lottery's plan to introduce a revised beneficiary timetable in FY 03. When the Departments of Game and Fish and State Parks raised this issue earlier this year, the Lottery performed an internal analysis and also requested an external independent interpretation of the distribution schedule. Both concluded that neither the Local Transportation Assistance Fund nor the County Assistance Fund have a priority position for deposits.

It is important to point out that the annual distribution amount has always been the statutory requirement based on game sales. At no time did the current distribution timing affect the end-of-year contribution to any fund. A new policy will be developed to reflect the revised interpretation.

Recommendation 2. The Lottery should supplement its *State Accounting Manual* - based procedures with additional accounting procedures for lottery-specific transactions, such as automated weekly revenue collections from retailers.

Lottery Response 2. The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This recommendation is consistent with the efforts initiated in September 2000 by the Lottery and continuing toward a completion date this year. For several years, the Lottery has either followed agency-specific accounting policies or the General Accounting Offices (GAO) procedures for state agencies. Both formal policies have been used to protect the fiscal integrity of the Lottery. This recommendation requires the Lottery to introduce more agency-specific policies consistent with GAO guidelines and will be completed before the end of the year.

SUNSET FACTORS

Lottery Response. The finding of the Auditor General is agreed to and the audit recommendation will be implemented. All of the rules identified in the audit have been prepared and will be reviewed by the Lottery Commission for submission to the Governor's Regulatory Review Council. The Lottery recognizes the need to promulgate these rules and will be doing so in FY 03. In the meantime, however, statutes and Lottery procedures are in place upon which the agency may act legally and properly.

Other Performance Audit Reports Issued Within the Last 12 Months

01-6	Board of Osteopathic Examiners in Medicine and Surgery	01-21	Board of Nursing
01-7	Arizona Department of Corrections—Support Services	01-22	Department of Public Safety— Criminal Investigations Division
01-8	Arizona Game and Fish Commission and Department—Wildlife Management Program	01-23	Department of Building and Fire Safety
01-9	Arizona Game and Fish Commission—Heritage Fund	01-24	Arizona Veterans' Service Advisory Commission
01-10	Department of Public Safety— Licensing Bureau	01-25	Department of Corrections— Arizona Correctional Industries
01-11	Arizona Commission on the Arts	01-26	Department of Corrections— Sunset Factors
01-12	Board of Chiropractic Examiners	01-27	Board of Regents
01-13	Arizona Department of Corrections—Private Prisons	01-28	Department of Public Safety— Criminal Information Services Bureau, Access Integrity Unit, and Fingerprint Identification Bureau
01-14	Arizona Automobile Theft Authority	01-29	Department of Public Safety— Sunset Factors
01-15	Department of Real Estate	01-30	Family Builders Program
01-16	Department of Veterans' Services Arizona State Veteran Home, Veterans' Conservatorship/ Guardianship Program, and Veterans' Services Program	01-31	Perinatal Substance Abuse Pilot Program
01-17	Arizona Board of Dispensing Opticians	01-32	Homeless Youth Intervention Program Letter Report: Department of Environmental Quality—Fiduciary
01-18	Arizona Department of Correct- ions—Administrative Services and Information Technology	01-33	Department of Health Services— Behavioral Health Services Reporting Requirements
01-19	Arizona Department of Education— Early Childhood Block Grant	02-01	Arizona Works
01-20	Department of Public Safety— Highway Patrol		

Future Performance Audit Reports

Department of Economic Security—Kinship Foster Care and
Kinship Care Pilot Program

Arizona State Parks Board—Heritage Fund